The Center for Economic Development
would like to express their profound gratitude to their sponsors
The Open Society Institute – Budapest and
US Agency for International Development
for the support provided
with the organisation of this Conference.

ISBN 954-98-06-4

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OPENING

George Prohasky

Director, Center for Economic Development, Sofia

Mr. Prime-Minister,
Mr. Deputy Prime-Minister,
Dear Members of Parliament,
Your Excellencies Ambassadors,
Dear Foreign Guests,
Ladies and Gentlemen, Colleagues,

Thank you for the interest in the conference "Factors for Economic Growth" in Bulgaria organised by the Center for Economic Development and the Agency for Economic Analysis and Forecasting with the co-operation of Harvard Institute for International Development.

We are pursuing several goals with this conference. Firstly, we would like to present the work of a group of Bulgarian experts over the last few months devoted to the problems of economic growth and the growth attainment factors under Bulgarian conditions. You have already received the papers in written form. Now you will hear summaries and then we will discuss the information, their standpoints and ideas.

Secondly, we would like to hear the opinion of foreign specialists whom we have invited to discuss these issues. We have with us today Prof. Jeffrey Sachs and Andrew Warner from Harvard Institute for International Development, Prof. Dabrovski from the Center for Social and Economic Research (CASE) in Warsaw, Prof. Woergoetter from the Institute of Advanced Studies in Vienna, Paul Reynolds from Adam Smith Institute. It is a pleasure for us to have with us here Prince Kyril Saxe-Coburg from Lehman Brothers.

Thirdly, we consider it very important to begin a public discussion among experts and politicians in Bulgaria devoted to the issue of economic growth because we consider that now is the moment when, after achieving evident financial and economic stabilisation, Bulgaria needs to do its best to initiate a stable, non-inflationary and the highest possible economic growth aimed at resolving for a long period of time the basic problems of our economy and our society.

Our goal is not so much to complete our work on those matters with this conference but rather to mark the beginning of a long-term orientation of the activities of the Center for Economic Development, the Agency for Economic Analysis and Forecasting, and I hope of a number of other Bulgarian institutes where those issues should be considered seriously.

It is a pleasure for me to call upon the Prime Minister of the Republic of Bulgaria, Mr. Ivan Kostov to open the conference.

OPENING ADDRESS

Ivan Kostov

Prime Minister of the Republic of Bulgaria

I would like to congratulate the organisers of this conference since here, well on time, a start will be given to the discussion of a problem, which is of extremely great interest to everybody in Bulgaria. Naturally, the issue about economic growth and its enhancing becomes topical, after we have successfully solved some of the most important problems of the economic and financial stabilisation.

All of us agree that stabilisation without economic growth will not provide Bulgaria with what it needs namely success in increasing its competitiveness and recovery of the incomes. That is why all politicians and economists, observers in Bulgaria, pose the issue about enhancement of economic growth.

And this serious discussion will start quite well on time. In order to have a fruitful discussion, it is necessary to explain in a convincing way the initial situation first. I suppose this will be done here. In almost the same way we need to assess the current situation as containing the initial prerequisites for economic growth. Otherwise, if we do not do so, we run the risk of having different opinions on the Bulgarian economy and by different I mean differing from professional point of view.

That is why I hope that one of the tasks of the discussion will be to find out common underpinning assessments of the situation in Bulgaria at present, in order to use them as the basis for identifying the factors for speeding up economic growth.

This year Bulgaria will definitely achieve growth. The question is how big it will be and what factors will cause it. This is the second major issue. I would not affirm here, of course, that the executive power and the politicians have many possibilities to influence the economic growth factors. However, it is quite obvious that Bulgaria possesses certain capacity and possibilities, such as the executive power, the legislative power, and is able to do what is required for enhancing economic growth. I hope this will be second important topic that will be discussed and on which recommendations for the management of our country will be formulated. And I assure you that we shall pay serious attention to these recommendations as we would not pretend that we know all the answers about the Bulgarian economy. We are clearly aware that both in the first topic that I tried to formulate and in the second one there will be a lot of unknown things, a lot of blanks about which we have not thought profoundly and sufficiently. It will be good for us to have also the opinion from a different point of view. This is the other big advantage of a conference like this one. The administration is always busy with current tasks, it always strives to fulfil its programs and that is why it cannot stand aside and have a look at neither the situation in the country, nor its own activities. That is why such a conference will definitely be useful.

I would not like to open up preliminary discussions at this point, but it will be good if opinions, strongly critical to what is going on in Bulgaria, are announced and discussed. Such strongly critical opinions, not approving of what has been done as well as rejecting the prospects outlined by us. Yet, there is one thing that I would like to prevail in the discussions – the positive approach to overcome the negativism and the race to prophesy bad future days for Bulgaria. For nine years now we have been witnessing a situation of extreme negation, of rejecting absolutely everything, under which circumstances we are trying to find a solution for the future. However under the conditions of a complete negation no concrete steps can be identified. That is why I wish the spirit of looking for decisions to prevail here.

A man once made a brilliant remark, he was a man that had done a lot in his lifetime, and who is proud of being a Bulgarian surgeon; he said: “It is not sufficient to say that something is not going on well, it is not enough to point out the weaknesses, what matters is to say what should be done, what is important is to offer something constructive”. I believe that the spirit of constructiveness will dominate. Bulgaria is fed up with gloomy forecasts. I am absolutely convinced that even the people who make such forecasts, to a great extent they themselves do not believe them any longer.

We have achieved a lot in the recent two years. “A lot” means that we have stepped back from the precipice into which we had almost already fallen. These achievements required a lot of effort. But a completely different effort is necessary now when we are trying to identify the practical steps ahead. This is an effort of everyday work, of gradual finding out the possibilities of our country, of looking for answers to the questions, and not of announcing verdicts, not of throwing accusations for what has been done, but identifying the really positive steps forward. Everybody in Bulgaria needs more practicality and I believe that mainly our foreign guests will help us find out this road of moving ahead. We need clearly formulated objectives ahead of us, feasible objectives, and afterwards describing the steps, which should be implemented.

What I can promise on behalf of the executive power is that with great commitment we shall abide by our programs in order to fulfil them. In this, I declare, we shall differ from everybody before us. We are going to fulfil what we have planned and we shall follow the identified track no matter of the cost for us. Because it was enforcement that Bulgaria was lacking, and not good intentions. So if this conference achieves positive developments, if useful recommendations are outlined here, we are prepared to fulfil them, i.e. to be the real executive power, fulfilling the good ideas, fulfilling everything useful, all useful recommendations. So I would like to assure you that this conference will be useful for all of you present and of course, for our country, too, because it needs a consensus, it needs unity when solving such problems and issues. Because the issues of economic growth really concern everybody, each and every Bulgarian citizen. There is no other recipe for improving the lives of the Bulgarians, for finding out the Bulgarian niche in Europe but economic growth. This is our common opinion.

Concluding my short speech, I would like to greet you all, to wish you successful work and to promise you once again that our government will cooperate completely. Thank you for your attention.

POTENTIAL FOR GROWTH OF THE BULGARIAN ECONOMY

Alexander Boshkov

Deputy Prime Minister and Minister of Industry

The objective of the governmental economic policy is to increase the economic welfare (the consumption) of each citizen and the society as a whole. This can be done in a sustainable manner by increasing the quantity of all goods and services per head of the population, which are produced in the country (GDP per head of the population). In a market economy only goods and services that are valued on the market find their customer and recover the resources spent for producing them, create conditions for expanded reproduction within certain economic unit and the economy as a whole.

Economic theory contains formulations of the basic factors for economic growth in market economy (the so-called Sollow's and Robert Barrow's models). For several months now the Center for Economic Development and the Agency for Economic Analysis and Forecasting have been working upon the basic issues for the formulation of the major problems related to the effect of these factors under the Bulgarian situation. Some of the conclusions will be announced to you at this conference.

In these opening remarks I would like to describe the particular features of the situation in our country and afterwards, the formulation of the tasks of the governmental economic policy.

I will start by saying that, unfortunately, in our country until recently we could not speak of a normal market environment and application of the market measures for enhancement of economic growth.

Our task was to lay down the basic pillars of a market economy, namely:

- basic economic legislation
- institutions of the national economy including financial institutions, social security system, anti-monopoly legislation and the related to it self-regulating authorities, etc.
- achieving big portion in the economy of private independent economic units by means of privatisation of the economy and incentives for the newly occurring private business
- adequate taxation system
- judicial system that works
- law enforcement system
- optimally organised state administration.

Only in the presence of the above mentioned elements can we speak about market economy – that is functioning either well or poorly – and look for ways for its improvement, its productivity and the factors for its fostering.

We consider that such a basic condition at a time when we have already overcome the political, economic and social chaos, when we have shaped strong pillars for the market economy and have made it manageable within the framework of market economy models, will exist only in the year 1999. Therefore we speak about completion of the foundation-laying reforms and the beginning of a typical *state economic policy for achieving long-term economic growth* – a policy, which is typically followed by the governments of most other countries.

Within this policy the time has come for us to consider more carefully what market economy we have got or we are about to establish and to outline the ways for achieving growth.

1. The first of the factors, which I would like to mention, is *the preserving of macro-economic stability*.

We continue believing that a major factor for achieving economic growth is the overall macro-economic stability, which is based on the principles of a currency board. Recently more and more the concept is launched that the fixed currency exchange rate has negative effect on the Bulgarian production and export and that the Bulgarian Lev has to be devaluated. I need to make two points here:

⋗ The positive effect of devaluation upon production and export is questionable – after a correction of the currency exchange rate the prices will quickly start increasing and will compensate the national devaluation. We have already seen this in the period 1991 – 1997. It was not possible to establish statistically the correlation between the export and the actual currency exchange rate in this period.

⋗ The negative effect of the cancelling of the currency board, however, will be enormous; each stabilisation program can be successful only if it enjoys the trust in the implemented policy; the rejection of the policy implemented by now will cause a feeling of uncertainty and instability which will result in a number of negative responses by all economic players; some of these responses are difficult to predict, others are sufficiently predictable and we would not let them occur.

We will keep the inflation rate low, although the situation of 1998 will hardly occur again with 1 % cumulative inflation, because we had also a considerable deflation influence from the international situation. Alongside with the condition of a currency board, a means of anti-inflation policy will be the timely adjustment of administrative prices and not allowing abuse of monopoly position in economy. The government is not going to implement social policy through prices, but through granting benefits to those groups of the population, which cannot pay for some goods or services.

The next factor for maintaining macro-economic stability is achieving a balanced budget, which will allow for gradual decreasing of the state debt and decrease of the interests paid from the budget. Furthermore that the fiscal policy by means of issuing Government security bonds directly affects the basic interest rate and thus, the economy as a whole.

Issuing more Government security bonds will also redirect private investments to giving credits to the government rather than to the real sector.

An important revenue component in the budget at present is the money from the privatisation. We should make use of them for solving long-term problems and not for current expenses. Restructuring of the large production units and their privatisation, the initiation of the pensions and health reforms, the infrastructure and the other investment projects will be the main spheres in which this money will be spent.

An essential connection exists between the development of the economy and growth and the structure of revenue and expenditure in the budget. The policy with regards to this is especially important under the conditions of maintaining low deficit. We reduced the subsidies for inefficient productions from 14,9 % of the GDP to 0,8 % in 1997 and to even smaller percentage in the last and current year. We are definitely moving towards partial self-funding of health care and education systems, towards more serious reforms in the social security system. We shall attempt to allocate bigger budget amounts for local goods and services, and also to direct the expenses for projects (such as infrastructural ones) which will indirectly enhance the productivity of the private capital.

Alongside with the above we realise the necessity of enhancing the economy by means of a taxation system which treats equally the economic actors and collects the needed revenue by means of lower tax rates applied to a wider basis, by means of equal taxation of the state and private sector, by means of a more professional tax administration.

All these measures will preserve the achieved macro-economic stability, will increase the trust of the Bulgarian and international business which will inevitably result in more investments and thus in higher productivity of the economy.

2. The second group of factors that should be employed in order to achieve economic growth is related to *the possible measures of the economic policy affecting the supply*. Major attention should be paid to corporate and personal savings and to directing them into the investment process. Concerning the corporate savings it is important a good depreciation policy to be devised because the greater part of more favourable depreciation rates including partial ”investment tax credit“ and the percentage of the value of the investment made will be recognised

for eligible to be deducted from the taxable profit. For the different sectors which the government would like to specially enhance or due to the essence of the production in them (e.g. high technology) reimbursement of the capital during the first year may be introduced as well as some other more flexible forms of taxation.

The savings of households are another important source, which should be made to operate by making the banking system more active. Alongside with this it is necessary to put into operation also the capital market as a means of directing the savings to the real economy and other market purposes. In this respect different and all possible ways should be employed to support the best companies (state and private) for entering into the official market of the stock exchange and the issuing of corporate and municipal bonds.

Undoubtedly the investment behaviour depends both on the availability of funds with the companies and the population, and the estimated net rate of return, the sales dynamics and other factors, which in turn depend on a number of economic parameters at macro- and micro-level.

3. The further development of the financial system is an important independent factor for the economic growth of the country. The fact that at present bankruptcy of banks rarely occurs is not an indicator of a good situation of the financial system. In Bulgaria the ratio of the total assets of banks to the GDP is only 35%, while in the developed countries it is more than 100%; the typical mortgage and investment banks do not exist; the offered banking services are a small number and of poor quality. The competition on the financial market is vague. There is an enormous amount of money, which is kept in cash as well as turnover kept in cash.

The financial sector policy should be oriented towards increasing the capital resources, improving the security of bank transactions and development of long term financing. This will be achieved by means of the privatisation of state-owned banks, their consolidation, and by entering in the Bulgarian market of powerful foreign banking and other financial institutions. Competition will inevitably lead to specialisation, diversification of services, clear orientation of the separate institutions. It is necessary to continue the efficient bank supervision and to prevent the re-occurrence of the practice of accruing bad debts. Alongside with the above the banks should have the required freedom to work and grant credits because credits are the basic mechanism for financing the growing business. The condition of the financial sector should be regularly analysed by the government, the Bulgarian National Bank, the banking and business associations and also methods should be sought for its strengthening and development in view of achieving the objectives of economic growth. With regards to this we established a good practice at the discussion of the latest amendments to the Banks Act and we should continue applying this practice.

4. An extremely important group of factors for fostering economic growth is related to *the behaviour of the economic units (companies) at micro-level*. They should be driven only by the strive for increasing the economic performance of their activities and their managing bodies should have a strong incentive for achieving such results. For this purpose the companies should have responsible owners, which we will achieve when the privatisation is completed in basic terms in 1999. The deteriorated international situation and the organisational, legal and other difficulties will not scare us, and each state-owned company that has an applicant-buyer will be privatised in 1999. Our basic criterion will be to find a responsible and accountable owner.

At the same time efforts should be made for improving the corporate and management culture in the big public companies. They should be managed but also the interests of the small shareholders should be protected.

Since a certain number of big companies should still remain state owned, the management of their assets should be improved. We have prepared a draft of amendments to Ordinance № 7 of 1994 of the Council of Ministers with regards to this and the purpose is the companies that will remain state owned to be managed more independently and marketwise.

The improvement of the corporate and management culture in the economic sphere is a task, which cannot be tackled by the state. This is a field where efforts should be made by the business itself, its associations, the non-government centres and foreign partners.

5. The next important factor for achieving economic growth, which can be influenced by the government, is *the infrastructure.* Without substituting private investment in it, we can create better conditions for attracting them, in certain cases also by means of state guarantees and by spending a part of the budget for that purpose. For 1998 the available surplus in the budget made it possible to make capital expenses amounting to USD 181 million. For 1999 this amount is approximately USD 361 million. Total for the period 1998 – 2001 the amounts from the budget allocated for capital expenses, state-owned enterprises and external grants will be approximately USD 5 billion. The major part of them will be spent for infrastructure projects. It is of great importance for us to establish better organisation of the process of preparation and implementation of infrastructure projects. We shall direct our attention to the assessment of the social economic importance of the projects and their meeting the international environmental standards; we shall give priority to projects with high level of readiness due to a longer period of their preparation.

6. The required conditions for developing and adopting a long-term strategy for priority development in the field of technology already exist in Bulgaria. *The technological level of the economy* is a separate group of factors for high growth and productivity. On one hand, we need to pay attention to the technological re-furnishing and development of all industries, on the other hand, to the development of industries, which ensure the designing, and production of high-tech machines, materials, software and services. As it is known, these are the most dynamic industries in the world and they can contribute substantially to the economic growth of each economy.

Bulgaria has good reasons to direct some effort also for recovering its high-tech productions. We do not intend to create again state-owned production structures, which need artificial conditions to be created for their operation. At the same time it will be difficult to compensate for the lagging behind without assisting the companies in this respect, and this assistance can be – if not lower taxes, then at least – more convenient taxation regulations allowing for faster depreciation of the equipment; it can be also information, marketing, patent rights, form of orienting the scientific potential towards production assignments; it can be also the education. We are drafting a strategy for the development of high technologies in Bulgaria and we shall submit it to the government in February this year. Simultaneously we are working upon a draft act on high technologies and high-tech parks which will grant a definite framework of preferences for their development. Still by the end of the summer this year the structuring of the first high-technological park in Sofia will be initiated; its design is being prepared at a fast pace together with the other relevant documentation.

7. *The greater export orientation of the economy* is related to the other important group of factors for achieving economic growth.

Bulgaria has a small domestic market and narrowed domestic demand. These circumstances cannot be radically changed. The desired outcome will be complete orientation of the Bulgarian economy towards foreign markets. The development of international export productions will have important impact on the general economic stability and the balance of our current account. At the level of economic policy this requires consistent and complete liberalisation of the export-import regime. Since the beginning of 1999 we have made a decisive step by the accession to CEFTA and signing bi-lateral agreement with Turkey. What is also important is our consistent policy for the implementation of the European Union Accession Agreement and the creating of prerequisites for initiating negotiations for full membership in the EU. This will finally solve the problem of the limited domestic market.

It is necessary also to bring to an end the process of removing the different non-tariff restrictions to import and export and the government to find an appropriate form for supporting the exporters – information services, efficient issue of our diplomatic missions for economic promotion of Bulgaria, direct assistance for developing and penetrating on new markets, consultations with regards to foreign trade regimes, investment policy, legal aspects of international trade activities.

A decisive improvement has to be achieved in the possibilities for export crediting and insurance in which sphere Bulgaria is really lagging behind.

I would like to emphasise that the government does not intend to implement sectoral policy and create artificially better conditions by means of hidden subsidising certain export industries. Such policy will result in inefficient spending of big amounts of money without achieving long-term effect. We realise that in some industries there will be a drop of the exports and for a certain period of time there will be a negative trade balance in the economy as a whole. This is inevitable under the conditions of restructuring of the economy. Only in a situation of a full clash with international competition, however, we shall be able to develop new productions, which will be the basis for the future export expansion of Bulgaria.

8. Both in the sphere of foreign trade where deregulation and liberalisation are important stabilising factors, and in the economy as a whole, we need to find *the most appropriate balance between establishing the required order, rule of law, protection of the property and other rights of the economic actors on one hand, and on the other, the creating of adequate opportunities for free initiative and entrepreneurship.*

The effort for establishing a modern legal and administrative framework of the basic economic and other relations in society has resulted in a number of new institutions and rules, such as giving state concessions, licensing, registration and strict control. This made it possible to established the necessary order, protect the citizens against abuses and gross lack of professionalism in spheres such as insurance, banking, communications, capital market, etc. By achieving certain stability in the different spheres, with the increase of the public culture and awareness, with the devising of self-regulative institutions of the economic actors in different spheres the role of the state should gradually decrease and become less and less noticeable. This can be achieved gradually and become an additional factor for enhancing economic growth in these spheres.

9. An independent generating factor, which promotes the economic activity and growth, is *the protection of property rights.* What is needed is a clear protection of private property and the opportunities for its economic realisation – without unnecessary bureaucracy, but with prompt and categorical intervention of the state authorities including the law enforcement bodies and the court for solving property disputes and for preventing encroachment upon the private and state property. This will arouse trust between the economic actors and will encourage them to undertake the necessary risk for developing economic activities.

This is the orientation of the reform in the judicial system. Alongside with it is necessary, probably, a special survey of this issue to be conducted and to carry out reviews constantly for establishing weaknesses of the legislation, the judicial and administrative practices. For this purpose we expect to be supported by business associations, research centres, associations of lawyers some of which took part in the discussion for the preparation of this conference.

10. The last (but not least) group of factors for growth that we should take into account is *the role of education and science.* Good education of the work force is one of the basic prerequisites for economic growth. In this respect Bulgaria is in good position on one hand, because the level of education of our employees and specialist is given high evaluation.

On the other hand the expenses for education have been strongly reduced in the recent years, namely from 6 to 4% of the GDP.

A great portion of the money is directed *for salaries,* while teachers and lecturers are paid poorly. The educational system should be restructured, the study curricula should be up-graded, and foreign languages should be studied at a larger scale, as well as economic and social sciences in combination with mathematics and computer knowledge. The private sector should be more active in financing education, science, research and development. At the same time the expenses of the state for science should be tied up directly to the contribution of the scientific centres, for improvement of the overall business environment in Bulgaria.

With the accomplishment of the basic structural economic reforms in the country more attention should be paid to the education system and the system of state scientific institutions since they are an important prerequisite for economic growth.

Concluding, I would like to emphasise the following.

1. Bulgaria has the basis of conditions for economic growth.

2. It is clear which are the directions for the future efforts and work at the governmental and other levels in view of putting into operation the factors, which enhance growth.

3. A wide consensus is required concerning these measures as well as concerted efforts inside Bulgaria and at international level by politicians, diplomats, the state administration, scientists for putting into practice these efforts.

If the Bulgarian society and its elite work studiously and in co-ordination, in my view it is not unrealistic to be able in some of the years of the next decade to achieve growth expressed by two-digit figures. Undoubtedly this is the most optimistic option for Bulgaria, which will result in considerable increase of the welfare and will create the best possible prerequisites for full membership in the EU. I think we should not be scared of high objectives. This is the only way for us to achieve the best outcome for Bulgaria and all of us.

THE ECONOMIC GROWTH – MODELS AND APPROACHES

Professor Jeffrey Sachs

Director, Harvard Institute for International Development

Let me say what a great honour it is for me to be participating in today's conference and to give my small tribute to co-host this event on behalf of the Harvard Institute for International Development and my colleague Andrew Warner who works closely with his Bulgarian colleagues here. We are especially pleased that we could join the Center for Economic Development and the Agency for Economic Analysis and Forecasting to share in today's proceedings.

I listened very carefully to the remarks Mr. Deputy Prime-Minister has just made and I have to say I listened with very mixed feelings, because on the one hand it was a wonderful, really wonderful speech and on the other hand he said almost all the things I had intended to say. I can find almost nothing to disagree with. In fact there is hardly anything essential to disagree with. I just have to find the things to add, amplify and underscore. My own experience here of two years ago, then one year ago, and at present, tells me of the great importance if this spell of time for Bulgaria. I think there is no doubt that this country is undergoing a wonderful and breath-taking Renaissance. In the last two years we saw what a remarkable power democratic renovation has and what a remarkable power the economic reform has, and what a remarkable power a good government can yield. So in my opinion Bulgaria today is indeed in the position to think ambitiously about the future and not just try to survive from hand to mouth or cope with past disasters. That's why it is so exciting to be thinking about the long-term future today, and not about what is going to happen today or tomorrow.

On that line of thinking maybe it would be helpful to start with a very abstract idea about the economic growth and then to move from the extreme abstraction to the very particular. Abstractly, economic thinkers over the last 200 years have identified three kinds of sources of economic growth. I consider it important to keep them in mind in the process of developing the Bulgarian strategy for achieving a double digit economic growth in the future – a target that I very much like.

One version of the theories of economic growth is that it is a result of savings and investments. The economic growth in itself is accumulating more and more capital, more and more capital per worker and thereby raising the amount of output per worker.

This is the most simplistic view of the economic growth. It used to be the view that underlay the numerous socialist theories of economic development. The basic idea was more factories, more savings, more investing, which would evoke economic growth. This proved to be a very limited view, as I will make it clear in a moment.

The second kind of theory of economic growth, as you know, actually started 222 years ago with the publication of "*The Wealth of the Nations*" by Adam Smith. We have a representative of the Adam Smith Institute at the conference – Mr. Paul Reynolds – whose participation here is very appropriate. Smith did not talk about savings and capital as being the resource and essence of growth. He talked about labour distribution, specialisation and producers networks, which lay in the economic growth. Adam Smith compared the farmer who lived by himself in his own farm, produced all he needed, built his own house as a closed economy to the urban centre where everybody had a very specialised kind of activity and it was the interconnection of highly specialised enterprises and individuals that raised the productivity in society.

So what was important for Adam Smith was mostly specialisation and what we now call in our world of the Internet the "network economy". The larger and more dynamic the network, the more productive any individual member can be. If you are part of an Internet network that has a few thousand subscribers, things seem simple. But think about the worldwide network that has millions of participants, all of them are far more dynamic than they used to. So for this purpose 200 years ago Adam Smith ago gave the idea of the economy as being a network of interrelations it seems to me that it is of vital importance for understanding Bulgaria's problems, too.

The third version of the economic growth concepts is related to the scientific and technological progress, and the network economy for the simple reason that genuine science is not the result of an individual genius sitting in the study, inventing a New World. The allusion is to a network of scientists each one participating in the division of scientific labour. The strength of a good scientist is the strength of his/her colleagues, the people that read his/her works, the journals that get distributed worldwide and generate new ideas in this network.

I do stress these very abstract ideas because I would like to emphasise that Bulgaria is moving from one kind of strategy of development to a quite different strategy of development. When Marks wrote about capitalism he wrote about capital. He considered capital accumulation as the core of economic life. When Lenin and Stalin talked about development, they meant how to squeeze the peasants in order to get more saving and build more factories. So the idea of growth meant more factories. This, however, did not turn out a very good idea because although saving and investment do have something to do with economic growth, this bit is too insignificant in comparison with the division of labour, the networks of interrelations that we live in and the scientific and technological progress that we can develop within those social networks.

Bulgaria has a lot of factories now but these do not produce enough. Even if they manufacture something it can hardly sell in many cases. So the question is will anybody buy them? Not will anybody pay for them, but will anybody take them for nothing?

The historic experience shows in n extremely tragic way that accumulation of capital comprises just a limited part of growth. What counts for Bulgaria more than anything in my view are the second and the third factors, namely Bulgaria should to be a part of the worldwide network of economic production and the worldwide network of science and technology.

For decades Bulgaria was forced to be part of a very limited labour division, that of the Soviet Union, in a network of technology created by force in a strive to compete with the worldwide network of technologies which finally failed. At present the main objective of Bulgaria having been part of a former, limited and failed network, is to rejoin the regional and global labour division, i.e. the labour division of Europe and the world as a whole. It is by being part of that international network of production and activities that the real value will come in a long-term perspective. Bulgaria does not have to reinvent the world's technologies, the country has to be part of the world's technological system in order to achieve the dynamic economic growth the country aspires to and which seems quite realistic to me.

If we look at the general situation of this country in very abstract terms again, not in the specific day-to-day terms, I think the conditions are quite favourable for that long-term development

It should be pointed out that in the world's current geopolitical situation Bulgaria is well located in Europe, close to the western European markets, close to the Middle Eastern markets and close to markets in the former Soviet Union. It is a kind of node in the international production network, the location is quite interesting, and interesting proves the best. It is a location with many positive aspects. Climate and agriculture are also quite favourable. There are many parts of the world where agriculture is developing in such unfavourable conditions that people cannot even figure out how they can survive. This is a country with potentially a very, very strong agricultural base, although the agricultural system was repressed for a long time.

As the Deputy Prime Minister said, the educational base for this renovation is very strong. In a way it is surprising how strong the science and education could remain under all of the difficulties that Bulgaria lived through.

According to my colleagues and me Bulgaria truly has maintained outstanding educational and scientific traditions which now ought to give it great opportunities. Due to this fact the basic position is quite sound. The main problem, however, is that Bulgaria is not currently a part of its regional or international network. To a great extent Bulgaria remains economically isolated, because the legacy of the past has not been yet overcome. In an abstract sense that is the biggest challenge that the country faces.

What is it necessary for Bulgaria to become part of the European and world markets? It is quite insufficient to establish a market economy. The main issue is how can Bulgaria become part of this regional and global labour division? You can hardly

enter into the Internet, unless you have the bandwidth, unless there is a way to make the transmission of information, or the transmission of goods, or the transmission of ideas. There is no network unless you have these preconditions. There are many software and hardware components of that network to connect. I shall name five of them.

First, the transaction costs of doing business. Is it possible to do business in Bulgaria, especially business between Bulgaria and Western Europe? How big are the transaction costs? By all accounts of the business community they are still too high. Too much red tape, too little transparency, too many hassles, too much petty corruption, and too many difficulties in making those transactions.

Second, finance proves to be a key issue in the network. Financial flows have to support real economic activity and we know that the financial flows are not working that well now. The financial markets have not recovered yet; there is no long-term financing available in Bulgaria; and foreign investors are still very cautious about making the connection between the international capital and domestic markets.

Third, of great significance are the physical infrastructure and the connections it provides. The expenses of these connections are too high. In my opinion, the roads are not good enough for businessmen and crossing the border takes too long. Is it right to have one road only and one checkpoint only at the border with Romania? That is neither a connection nor a network. That is a bottleneck.

What Internet access do you have and what price do you pay? What kind of telecommunications are there? What is their price? These are crucial questions in modern economic growth because it is these that establish the real networks on which business is done.

Next come the networks on a sectoral basis, i.e. the relations among the real producers. For all of the remarkable achievements in last years there is still no establishment at a sectoral level of Bulgarian production and Western European production or very primitive.

As far as the exports are concerned we can find an explanation in the artificial division of labour in the past – what Bulgaria used to export and sell was sold on a purely artificial basis, because of subsidised energy, for example.

The question is how to establish new network links in the real sector? There are some signs of progress, but it is still weak. There is true organic growth in textiles and apparel industries. Bulgaria is exporting on a market basis to Western Europe in an area where it was not before, the business is growing, and that creates real value and real jobs. All this is carried out on a very restricted scale. And finally fifth, I would like to point out the state of science and education in Bulgaria. I was extremely happy to hear Deputy Prime-Minister Boshkov give an annotation of the system towards the end of his speech. I find it of utmost importance that Bulgaria focuses on higher education and science now and not let this advantage become weakened or dissipated because of the economic crisis. The national resources should really be devoted to maintaining the strength of the scientific community and higher education.

So those are the five areas that I would like to discuss in details and give you a few concrete ideas. There is no magic recipe for anything. I know of no big tricks to accomplish these tasks. You have managed to exercise the magic of transition from chaos to order. But the magic of becoming part of the international network is a longer-term work. And I do not think things can be accomplished overnight. Yet, some ideas can be helpful. Probably you know most of them.

First, on transaction costs. I see at least a couple of areas where improvement of the present situation really needs to be made. I think the effort is on the way, but it can be enhanced. First, Bulgaria will become part of the EU within the next few years if it makes the effort. I'm not sure of the opinion of the EU on this issue it might happen sooner than the EU presumes. How fast it will happen will depend on Bulgaria's own efforts.

Getting into the EU and adopting the basic law of the European community, the so called achievements of the community's rights, will be the major way to reduce transaction costs, because the EU has rules that link economic agents. Being part of the European legal system will be of crucial importance for economy. I hope that the government is systematically and progressively renovating the entire legal structure for harmonising it with the European law on a timetable, which will lead to fast entry into the EU. Just parenthetically the EU has not set timetables and limits for harmonisation of the legal structure is a hard work. There thousands of codes and laws, but they really needs to be ratified as fast as possible.

Related to that I would like to stress on the need to upgrade the judicial system. This is not easy to do, because unlike a currency board, there is no way to magically reform the judicial system. There is a very serious concern among international business circles about the state of the judicial system. It does not seem to be functioning transparently, clearly and rapidly in order to be able to enforce the law or contracts. May be the involvement of the international arbitration and mediation, and the various conciliation mechanisms may improve the situation although this will not substitute the judicial reform entirely.

Second, as the Deputy Prime Minister said, the financial sector linkages still need improvement. I was very pleased to hear about the need of the presence of the international bank here which offer a full range of bank services. There are a lot of international banks with branches or representative offices here but they do not offer the full range of bank services. Unless the country joins the international network, the financial sectoral sector will remain too week.

I think more attention needs to be paid to creating a long-term finance resource in the country. I will remind the audience that in the US, the home of the free market, our mortgage market is supported by government guarantees through the Federal National Mortgage Association. It was not possible to have a national mortgage market even in the US economy until there was government backing for securitised mortgages. I think there needs to be some creative thinking about how to support long-term financing on a market base, of course, and with some more determined government backing. This may sound a little bit heretical, but I will stand by such a proposal because long-term finance is really important to get the economy to achieve the long-term growth. Second, we know that there need to be important improvements in financial law. On the one hand we have lending and on the other hand we have guarantees of the creditor's rights when the debtors is in a position of insolvency. It is significant to fill the gap in the legal and judicial system.

The next area that I have mentioned is the infrastructure. Let me just underscore one obvious point that you all know and yet it needs emphasis. The international network of production depends more and more on information technologies. Even the most humble sectors of an economy now require an extended access to the international networks, the Internet and the intranets of different enterprises and industrial branches at a low cost basis. Otherwise this kind of participation in the international division of labour is not effective enough.

Things have changed in the last five years. If your company wants to bid on a supplier contract, it should present its offer on the Internet. This will not be possible unless this economy is wired up to the international environment and this in itself requires a lot of attention to the infrastructure backbone of the economy. It is necessary to provide the amount of bandwidth in order to realise the cost at which they are provided. As far as I understand 'America on Line' does not have local Internet provision here. This fact is worth stating to the companies providing information services. You have so many excellent software and computer firms, and specialists here; this problem may be solved if the regulatory bodies pay more attention to it.

I would like to stress how crucial Internet has become with the electronic commerce, which it offers. Electronic commerce comprises an ever-increasing part of international trade. I'll give you just one example to illustrate this meaning – the textile company on the island of Mauritius, humbly and ambitiously they sell shirts in London. This is the kind of business that many Bulgarian companies are trying to get in. How does the company manage to keep their loyal buyers in London? A few months ago they created an information technology system in Mauritius so that their clients in London can know exactly the state of production and shipping of every order. When in London you type onto the firm and you can immediately find out how many shirts have been sewn and on what date the shipment is to be ready. This is a very significant mechanism for them to remain competitive in the British market right now. How many of the Bulgarian textile companies have Internet use of such a kind? My guess is very few right now but even in this humble sector, that is a great competitive advantage. Whether clients will buy shirts from Mauritius or Poland or Sofia will depend on the networking and the kind of connection. This is going to be more and more important.

The fourth area I want to mention is the sectoral policy. Bulgaria needs industrial policy. Another heretical remark from a free market economist. Let me just clarify it. It doesn't mean that the government is going to set up enterprises, and become owner of enterprises; it does not even mean that the state is going to select the producer of the year. This means developing a branch in order to help re-establish the international network. For example, as the Deputy Prime-minister said, what kind of tax policy will apply for foreign investment in key sectors, high-tech industry, or in the apparel sector, or in agriculture, and so on. I happen to be a big believer from my own experience that tax policy is a critical variable for attracting foreign direct investment. I believe in tax holidays, for example, which many other economists consider sceptically? There exist rules of the game in order to attract the big firms to specific branches. Let me give you one example. I worked with the President of Costa Rica for two years to attract Intel to make a major investment in Costa Rica. They invested a 600 million dollars in a semi-conductor factory in Costa Rica, which had an annual turnover of over 3 billion dollars. This is a major change for Costa Rica. It was very hard to attract the company. In this way the base of the electronic sector is established. Intel took some study tours of Costa Rica and put Costa Rica on the list of the four most promising countries, i. e. Mexico, Malaysia, Ireland and Costa Rica. And it was a tough competition, which took a year. The President of Costa Rica was personally on e-mail with the President of Intel almost every day. Literally. "Tell us about your concerns, we'll solve them. We want to win this. We want to attract you here. Tell us what we need to do." In the end Costa Rica offered a 10-year tax holiday, it offered industrial land; it changed the customs administration at the airport and the local university. Intel planned a new university curriculum for electrical engineers.

That was the package deal in the end. Was it a good deal? No doubt, it is a hugely favourable deal for Costa Rica. For this purpose a whole campaign was undertaken like a preelectoral campaign. The conditions had to be tailored to the requirements of this major investment. Of course, you can't accomplish that every time and besides you don't need to do it every time. But in big deals, which prove extremely necessary on order to secure key sectors you, have to do that. You will need flexibility which means accelerated depreciation, lowering of the corporate tax rate, guarantee on land. These measures depend on the kind of sector, and the type of investment and sectoral strategy.

It's not a pure theory. And as you know even in the US the government with their fabulous attachment to free market work every day to attract investment from Minnesota to North Carolina, from Massachusetts to Arizona. So for this reason I encourage you to leave the economics textbooks and focus on a market-oriented and realistic strategy for key sectors. Which sectors do I have in mind? You know them very well, they all need development.

First, light industry – textiles, apparel, furniture, etc. Bulgaria has an obvious competitive advantage in these sectors. There should be a reconsideration of the tax policy and customs policy for competitive reasons.

Second agriculture and food processing industry – another area where there could be significant foreign investment because of the strong endowments here which are still not developed.

The third area is electronics and information technologies. You need Intel here or a similar big international company like Philips, or Ericson, or any other. They should be producing large scale here. What do you need to attract them? What do they seek for? How will you manage to compete Malaysia, Mexico, Costa Rica or Ireland?

Next is tourism. You have great tourist potential for foreign direct investment. Again we must find the answer of the question 'What kind of policies on a sectoral level will bring them here?' I would like to stress that in the practical world the prospering countries do have market-based industrial policy. Ireland has a 10% corporate tax rate; Costa Rica has given a major tax holiday. And it is a matter of pragmatism and response to concrete needs.

Finally, I shall once again underscore the importance of science and education base as a base of this economy. Even if you are selling shirts, a more humble sector compared to modern sectors, you need sophisticated information technologies. The same is valid for food processing industry as well. The information requirements for shipping your production to European and world markets are really high. Nothing can be done without proper science and technology. It is necessary to maintain and heighten the facilities of higher education. Bulgaria has a strong base to work on and the government needs to find mechanisms to enhance this – scholarships for Bulgarian students who study in Europe and the US; serious competition for those kinds of placements; programs to encourage local universities and local businesses to work together.

One of the peculiarities that we observe on a large international scale is that technologies now depend on the link between industry and university more than ever. The strong private sectors in the US are centred on universities no matter if we are talking about Silicon Valley in Stanford University, or Harvard, or South Caroline. Every major centre of industry requires a good university ground. That connection is not yet established in Bulgaria and serious work is to be done in this respect, namely to find a way to stimulate the co-ordination between the real sector and universities. I think the pay-offs of such an approach can be enormously strong.

So let me conclude at this point by saying that I am most pleased to be here, I am pleased with your ambitious objectives having in mind the international circumstances you small country was caught in. So far Bulgaria has operated below its national potential and you have quite real chances for a rapid growth. During the last two years there have been built the necessary base for achievement of this objective. A full and dynamic prosperity of the economy is really possible in the decade to come. Considering what you have accomplished so far I'm sure that you will make a next successful step.

MACROECONOMIC STABILITY AND ECONOMIC GROWTH

Rossen Rozenov

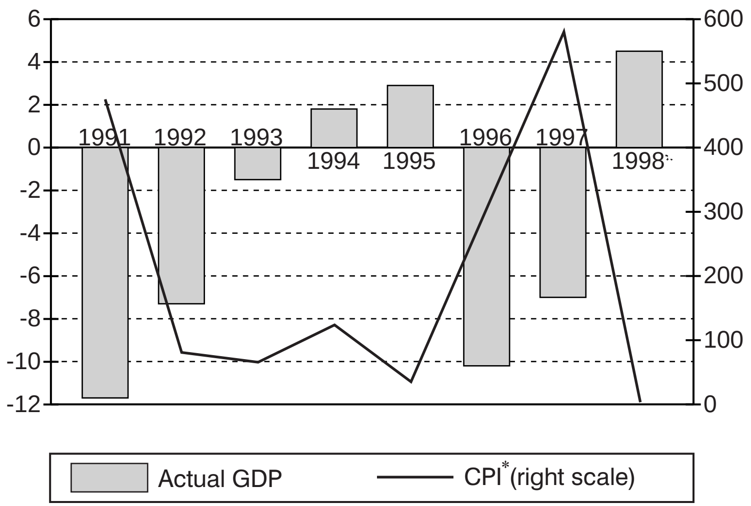
Agency for Economic Analyses and Forecasting, Sofia

The paper discusses macroeconomic stability and economic growth related questions. Special attention has been allotted to the effects of the economic environment on savings and capital expenditures as major economic growth factors. The paper concludes by making some recommendations for economic policy measures that could increase capital expenditures and savings rates.

Unlike the Central European countries, which managed to stabilize their economies and create conditions for economic growth rather fast, high inflation rate and a drop in the GDP have characterized the general development of Bulgarian economy

Figure 1

GDP Grwth and Inflation Rate (%)



* CPI – Consumer Price Index

Data source: National Institute of Statistics (NIS).

since 1991. Exhibit 1 indicates that there was economic growth only in 1994 and 1995, at a very low rate at that. On the basis of the data about the nine months, the expectations are for a GDP increase of about 4 – 4.5% in 1998 as well.

Table 1 shows the contribution of individual component elements to GDP changes from aggregate demand perspective.

Table 1

Contributions to GDP Growth

	1991	1992	1993	1994	1995	1996	1997	1998
Consumption	–9.5	6.6	5.0	0.6	–2.8	–6.4	–10.2	5.4
Capital expenditures	–10.5	–4.2	–4.8	–5.7	6.7	–8.1	2.6	3.9
Net exports	3.2	–9.7	–1.7	7.0	–1.0	4.4	2.1	–5.0
Difference	4.9	0.0	0.0	0.0	0.0	0.0	–1.4	0.0
GDP	–11.8	–7.3	–1.5	1.8	2.9	–10.1	–6.9	4.3

Data source: NIS, own calculations.

In literature macroeconomic stability is generally considered to be the major prerequisite for the achievement of sustainable growth. The dynamics of the basic economic indicators sends signals to businesses and households, which change their behavior depending on their expectations.

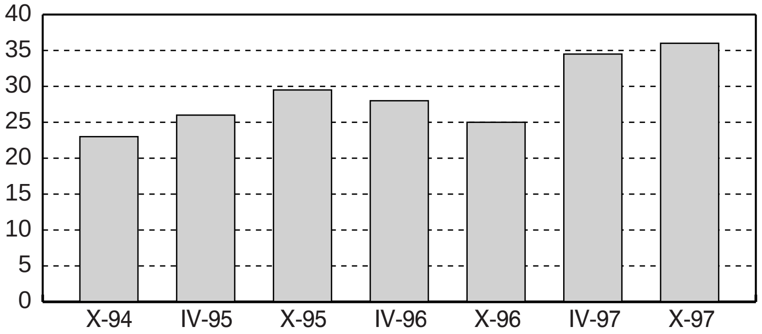
A trustworthy stabilization policy is very likely to revive economic activity in the country since such policy is conductive to long-term decisions. Conversely, an unstable environment, that cannot be predicted, has a stagnating effect on capital expenditures. High inflation rates result in significant changes in relative prices, which makes it difficult for investors to estimate return on capital.

The above arguments can be supported by some of the answers provided in the questionnaires on intended investments in industry, circulated by the National Institute of Statistics.

Before commenting upon the results, we deem it necessary to elucidate the method we have used. Questionnaires are filled out twice a year – in April and in October. The answers to the April questionnaire are to indicate capital expenditures in real terms, estimated for the current year, while those to the October ques-

Figure 2

Relative Share of Businesses which Intend to Allocate More Capital Expenditures in Comparison with in Comparison with the Previous Year (% of the Total Number)



Data source: NIS.

tionnaires – capital expenditures intended for the next year.

The Exhibit shows that investment intentions grow more intense in periods of relatively low inflation rate (1995 and after April 1997), and grow weaker in times of imminent financial instability (April and October 1996).

The NIS current economic set-up information of April 1998 does not contain any data about the distribution of firms on the basis of their investment plans. However, if a comparison is made of the amounts of estimated capital expenditures, it will show that they have gone up 1.6 times, as compared to the October 1997 figures. This could be assumed to be an indicator of the businesses' expectations for a more favorable environment.

An analysis of a stabilization program usually boils down to a mere analysis of its major components, i.e. monetary policy, currency exchange rates, present state of the budget and, sometimes, income policy.

Since July 1, 1997, the question of Bulgaria's monetary policy has been irrelevant, since the currency board in the country implies automatic determining of money supply.

The currency exchange rate level, however, continues to be a sensitive issue. There have been assertions that the fixed exchange rate has a detrimental effect on Bulgarian production;

hence, the BGL has to be devaluated. Adjustments in the exchange rate, however, might undermine the popular trust in the policy conducted and could generate apprehension of future devaluation. In addition, real exchange rate fluctuations in the 1991-1997 period indicate that, as a rule, the nominal devaluation of the Bulgarian BGL has always been offset by prompt increases in prices, which means that this cannot have a lasting effect on competitiveness. (The data available do not display any statistically significant relationship between exports and real exchange rates, therefore, the assertions in favor of a cheaper Bulgarian BGL are mere assumptions.)

The maintenance of macroeconomic stability is in close relationship with the fiscal policy, conducted by the government. A budget deficit, funded by the banking system, has a crowding out effect on private investments. A growing deficit is bound up to diminish government savings and if the drop is not compensated for by an increase in private savings (due to the multiplicator effect), the overall level of savings goes down. Given the current prime interest rate-setting system in Bulgaria, all other conditions equal, and the state of the budget has a direct effect on interest rate levels.

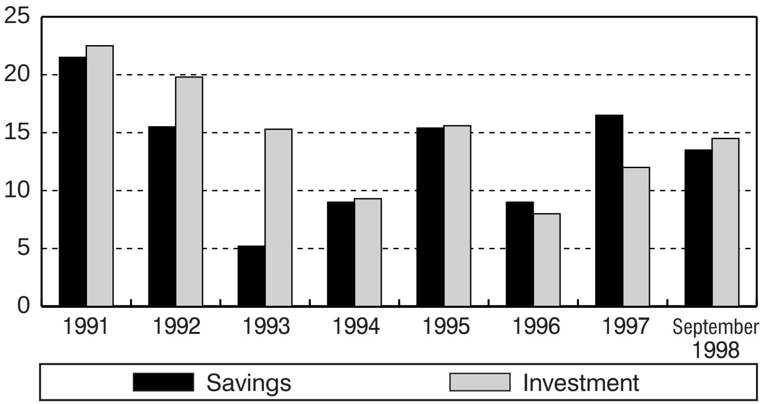
In addition to its stabilizing role, fiscal policy has an effect on economic growth through budget expenditures. If budget allocations are used for local goods or services, which are not traded on international markets, the expense incurred results in boosted domestic aggregate demand. The purchase of imported goods, however, as well as of commodities produced locally, which can be sold internationally, has no effect whatsoever on production. It only results in increases in the balance of payment current deficit. In this connection, the government investment program, which stipulates funding of the consolidated state budget to the amount of $ 1.3 billion, will have a significant effect on the economy, which will depend on the distribution of expense between local and imported goods and services.

Stabilization of the economy is *conditio sine qua non* for long-term growth; however, this is not sufficient. Potential investors could rather keep their moneys in liquid assets, rather than invest them in the real sector.

The low level of savings restricts all too often investments. In

Figure 3

Investment and Savings (in % of the GDP)



Data source: NIS, Bulgarian National Bank, own calculations.

an open economy the short supply of internal resources, which are to fund investments, has an adverse effect on the balance of payment current account.

The capital expenditures and savings rate in Bulgaria has gone down considerably since 1991 (see Figure 3).

It should be noted here, that the low investments/GDP ratio is not a characteristic feature of the transition period. For Slovakia, one of the Central European countries with the highest growth rate, the 1997 indicator was 39%, for Latvia it was 19%, and for Lithuania – 22% (according to European Commission data).

Bearing in mind the unfavorable trends in the dynamics of capital expenditures and savings in the past few years, some economic policy measures aimed at encouraging savings in the economy and transforming these into productive investments, is likely to step up growth rates.

In the public sector, reducing budget deficits usually attains this, while accentuating interest rates encourages private savings. Under a currency board, however, the relevant authorities have a relatively slim possibility of intervention, since the market sets interest rates. Tax policy is another powerful instrument for exerting influence upon investment decisions and savings in the private sector.

Unlike the industrialized countries, where corporate savings traditionally account for some 50% of aggregate savings in the

economy, households in Bulgaria were until recently the only institutional sector generating positive savings.

As a rule, most of the corporate savings in the country today are in the form of depreciation. The adopted depreciation scheme is of prime significance for the amount and structure of corporate savings in the course of time. In case of accelerated depreciation, the payment of the tax is deferred and savings accumulate fast at the beginning of the useful life of the asset. (In the extreme case, when the full investment amount is deducted from the taxable profit, all savings accrue within the first year, while the tax is paid in the periods to follow).

In view of stimulating investment activity, accelerated depreciation could be used in combination with investment tax loans. The investment tax loans do not merely postpone the payment of tax but directly cut it down. This mechanism played a fundamental part for the encouragement of investment in the USA, for instance, for about two decades.

There are accelerated depreciation allowances for tax purposes of the non-current tangible assets of the second type (machinery, production equipment, appliances, computers and software) as well as for electric energy carriers, communication lines, steam lines and water conduits in the Bulgarian Corporate Income Taxation Act adopted in 1997. A kind of investment tax credit amounting to 10% of the investment value made in the high unemployment rate municipalities was introduced by its amendment dated 23.12.1998. Three essential restrictions strike us therein: first, there is a preferential treatment of certain regions, second, the ordinance is applied only in the events when the financing of investments is at the expense of their own resources and third, the reduction of the tax is applied only to the assets indicated in Article 22, paragraph 2, item 1, i.e. for solid structures, equipment, transmission devices, electric energy carriers and communication lines.

Bearing the above-mentioned peculiarities in mind, the concessions envisaged in Article 60 of the Corporate Income Taxation Act divagate from the traditional understanding of an investment tax credit. One of the basic taxation principles has been violated – the neutrality principle. The solution of social problems by means of taxation re-distribution is not an economically viable one and experience also indicates that the introduction of preferences does not guarantee the achievement of the desired effect.

If investment demand stimulation is the real objective of the economic policy, an investment tax credit shall have to be ushered in for all the companies functioning on the territory of the country, no financing sources requirements should be set and the range should be expanded by including all the depreciable non-current tangible assets (with the exception of buildings perhaps).

Bearing in mind the significant decapitalisation of Bulgarian economy on account of the high inflation rate in the last few years, an even more radical approach could be resorted to for the achievement of rapid accumulation of corporate savings. Such is the method of “recovering capital expenditures in the first year”. It consists of the following: in the year of the asset acquisition a deduction is made adding to the amount of the sum total of the present value of all future depreciation installments. The discount percentage to be adopted at the present value calculation shall be applied for updating the losses carried over in future financial periods as well. The advantage of this method, which is an accelerated depreciation final variant, consists of inflation rate effect elimination and increase in the company’s free cash resources. However, there must be other investment-generated income to accomplish savings.

With regard to household savings, tax relieves for taxpayers that are most eager to save could also increase the supply of funds in the economy. Usually medium or high-income persons are in this category. There is no information reliable enough about Bulgaria’s population savings depending on their income. Yet it can be stated on the basis of NIS household income and expenditures observations that the average savings/income available ratio in the highest income persons group (over 165 000 BGL per month) is about twice as high as that of the previous group (from 150 000 to 165 000 BGL). The fact that the household budgets estimate results have been strongly ousted towards the poorer households since a large group of high income persons declined to participate in the research is to be taken into consideration as well.

Of course, such investment and savings increase measures could be eventually carried out on condition that adequate budget proceeds have been guaranteed. Otherwise, the budget deficit is bound to grow, which, in turn, would endanger macroeconomic stability.

COMMENT

Professor Andreas Woergoetter

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Congratulations on this wonderful event I am able to participate in. I would like to concentrate my comment on an observation.

The taxi driver that brought me from the hotel to this Wonderful Palace of Culture was charging 5000 leva and I only had a 10 000 leva bill. So he asked me whether I would mind to take 3$ change. For the first time it occurred to me that dollars would be offered here instead of the local currency, even at a more or less corrected exchange rate. In that respect we can say that macroeconomic stability has come to the everyday life of Bulgaria, and that is not a phenomenon of statistics, but of real life.

When we are talking about the relationship between the macroeconomic stability and economic growth, then my hypothesis, and that is what I would like to explain, is that macroeconomic stability is a foundation but not a substitute for economic growth. It is a foundation on which you can build a house but it is not the house itself. Macroeconomic stability itself is of course a prerequisite for growth. But in order for growth to happen, actually, many other things have to take place.

So macroeconomic stability is offering opportunities and it will translate into economic growth only when these opportunities are utilised. And the statistics that we have just seen should be alarming in the sense that it is still a long way to go for the Bulgarian economy to be able to utilise the opportunities of macroeconomic stability. Growth in 1998, estimated at around 4%, and decelerating into 1999 is not really what we would like to see as a successful and forward-looking response to the enormous macroeconomic stability that the Bulgarian economy has achieved. To be clear I would say the issue of macrostability is not an issue of choice for the Bulgarian economy neither for the Bulgarian politicians. That is of course linked to the currency board system and it was an outcome from previous failures. Of course we could wish for the much more beneficial flexibility of exchange rates, of Bulgarian National Bank carrying out an independent monetary policy. Unfortunately, Bulgarian policy makers in the past have proven so decisively and so clearly that hey are not able to use these opportunities, so that the international community has decided, at least for the foreseeable future, to eliminate any freedom of choice in that area. So, Bulgarian economy has to live with macroeconomic stability in order to benefit from it and contribute to growth.

Who is able to make use of these attractions? First, we think of those that are in need of loans and take credits at lower interest rates. Low interest rates are beneficial only for those that obtained credit. And therefore the reform of the banking sector is of utmost urgency; and it is of course very important that the interest rates are reduced not only for the state, but also for small and medium size businesses. This is the experience we can learn from with other economies. It is the expansion of small and medium size businesses that is bringing growth to the economy. That has been the case in Poland, the case in Hungary, and we could observe that in all of the OECD countries in the post-war reconstruction period.

Another attraction of macrostability is stable prices. Of prices benefit only those that command purchasing power and income. Therefore an efficient labour market, providing income opportunities for the population is crucial.

Macrostability and that have to be mentioned clearly, has costs and the costs are more or less determined by the efficiency of macroeconomic structures. One of the costs is the unemployment that you need in order to keep wages at a level that keeps your prices competitive on the world markets. The more competition you have on the goods and the labour markets the less restriction for market entry.

Another cost, more visible, is lower government expenditure. Here the main issue is the question of what is the level of tax revenues that the Bulgarian government is able to receive from the economy. The level of government spending is of course crucial for a catching up and growing economy. It is a very deep misunderstanding to think that in a market economy the state has no role. Especially in a dynamic market economy we need a strong state that is able to secure the framework for the private businesses, able to provide the crucial services in the areas of education, health, culture, research and also infrastructure.

In that sense I am fully in line with what Prof. Sachs said in his presentation. Coming back to the presentation of Mr. Rozenov, of course, investment and saving is crucial. He mentioned Slovakia, with its current 40% share of investment from of the GDP. I believe that we may observe quite a serious economic crisis in Slovakia over the next one or two years, when it turns out that these investments will not be generating the revenues that are necessary in order to pay back what has been invested.

A high investment rate as such may be an area of concern. A clear example of recent years is Indonesia, where investment rates have been very high. It turned out that the investment was channelled into the economy in such a way that did not really generate revenues.

Therefore we have to see macroeconomic stability and investment not in an isolated form, and not only be concerned with figures. We have to see it for the economy as a whole. In that respect I would say a lot remains to be achieved and to be done for the Bulgarian economy.

PRODUCTIVITY AND GROWTH: PRESENT STATE AND PROBLEMS OF THE REAL SECTOR

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The Real Sector in 1996–1997

The issue of ensuring conditions for stable economic growth is largely analogical with the issue of ensuring conditions for sustainable development of the non-financial businesses. Exclusively the situation and potential of the non-financial companies to expand their business activity and market share precondition the opportunities for economic growth. From this viewpoint, any restrictions levied over the expansion opportunities of the non-financial companies' pose as a factor influencing negatively the opportunities for increase in the rate of economic growth.

Data from the annual financial statements show that both the public and private companies, that constitute the two components of the real sector, have reached a positive financial result (profit) before paying interest, taxes, etc. extraordinary payments (earnings before interests and taxes – EBIT) in 1996 and 1997, and in 1997 there is an increment of 14% in the profit in real value as compared to 1996 (the above figure deflated with the average annual manufacturer price index). Profitability of the companies of the sample has also grown in terms of EBIT from 9,5% in 1996 to 11,5% in 1997.

The business activity of the companies however was reduced both in 1996 and 1997. In 1997 only the volumes of income from sales of the companies from the sample was reduced by more than 6% in real value. The growth of the operational profit of the companies in 1997 was mostly due to the high inflation during the second half of 1996 and the first months of 1997. Such a development – increased profit and profitability due to acceleration of the price dynamics – was observed in Bulgaria in 1991, as well as in some other Eastern and Central European countries (e.g. Poland in 1990). In 1998, which saw a reduction in the inflation rate to levels that are typical for developed market economies, the profitability of the state-owned companies was squeezed, which fact in itself however should not be seen as an indicator of deterioration of the positions of the public real sector. In the same way, accounting profits, engendered by changes in the price levels, are not an indicator of an essential improvement in the positions of the real sector in 1996–97. Other factors that also contributed to the increase in the operational profit of the companies, are the curbing of part of the costs in real value typically incurred in the basic operational activity, particularly labour costs and depreciation.

Data shown in Table 1 at the end of the text indicate that the distribution of companies from the two parts of the real sector is very similar. The companies of the first group, whose liquidation is very likely, if not inevitable, account for 17% and 18% of all private and public companies, involved in the sample in 1996. In 1997 their relative share was decreased to 12,3% for the private and 14% for the public sector. In the same time the companies with positive EBIT both in the private and public sector constituted 60% and over 60% of all the companies from the sample in 1996 and 70% in 1997.

The companies of the first group, which are the major loss generators in the two parts of the real sector have a relatively small impact on the size of output produced – around and less than 5%. In the same time, the companies with negative profitability account for a relatively high portion of the funds allocated for labour costs (compensation for employees, social security contributions, etc. payments related to labour salaries). This gap is the largest with the "weak" companies, whose relative share in funds spent on labour is about and more than twice bigger than their contribution to the size of output produced.

A similar model of behaviour of public companies has been observed in periods of transition.[1] What should be noted here is that the relative share of the group of the weakest companies was

[1]For more details *see*: *Avramov Roumen, Kamen Guenov* – The Economy of Transition: Structure and Types of Behaviour of Enterprises from the Banking Sector". "Bankov Pregled, No 3, 1995; and *Guenov Kamen* – Adjustment of the Real Sector to the Measures in the Macroeconomic Policies in "Prehodut", ed. R. Avramov and V. Antonov, Sofia, 1994, p. 139–159.

gradually reduced both in the volume of the output and in the size of funds paid for salaries.

The expenditure structure of Bulgarian companies differs significantly from the structure in other countries[2]. The relative share of labour costs from total costs in Bulgaria is much lower than the one in the East German provinces and this is a direct sequence of the low level of labour salaries in the country.

Many experts see the low level of labour costs as an extraordinary competitive advantage of the Bulgarian economy. Such a view may be well grounded from a theoretical point of view, still a great portion of the Bulgarian companies remain non-competitive at the international market. There are cases where this relative advantage of the Bulgarian economy is utilised (mostly in dressmaking and textile industries), but in general the low labour costs have not made Bulgarian goods more competitive. The most energy-intensive industries, such as metallurgy and chemical industries account for the greatest portion of Bulgarian exports (and these were supposedly the most competitive Bulgarian products). Hence, the major relative advantage of the Bulgarian economy was in the low price of the energy sources, which have been to a very high extent subsidised by the state budget either directly or indirectly.

The depreciation share in the total costs of the Bulgarian companies was relatively low as well. Bulgarian firms incurred costs on depreciation whose relative share was between 2% and 4% in 1996 and below 1% in 1997, while at the same time for East German companies it was approximately 6%.

Problems of the Development of the Real Sector

One of the main reasons for the low competitiveness of the real sector is the low level of its business management. The privatisation process, particularly the entry of highly qualified foreign management in the major industries, determining the structure of the Bulgarian economy, is expected to step up the quality of business management. The retention of state ownership

[2]"East German Enterprises Profitability anf Financing in 1995", "Deutsche Bundesbank Monthly Report", July, 1997, pp. 41 – 54.

over the major industries has a negative effect not only on the quality of their management and market policies, but on their investment policies as well.

A decisive accomplishment of the privatisation process would help resolve yet another essential problem of the real sector, namely – would place strict budget constraints on all economic agents in the country. These strict budget constraints are important not only in terms of improving the companies' competitiveness, but also with a view to the currency board functioning in the country. Generating budget deficits is impermissible in such conditions, since they could be eventually transformed into deficits of the state budget.

Of paramount significance for loosening the strict budget constraints on a micro-level is the increasing indebtedness of the companies to suppliers, state budget, commercial banks, etc. Whether the companies have been adjusted to the requirements of the market economy can be evaluated through the extent to which they service their debt to other economic agents.

The financial flows between the real sector and the state budget include budget subsidies allocated from the state budget to the companies, and taxes paid by the companies to the state budget. The state budget can also extend temporary financial aid to some companies, which is, in essence, lending by the government to the real sector, under conditions quite beneficial for the companies. If such financial aid is not claimed within the terms due as envisaged by the state departments, it can acquire the character of a subsidy rather than a credit.

The level of budget subsidies as compared to GDP has been significantly reduced since the beginning of the transition towards a market economy, as compared to the years of centrally planned economy – in the period 1995 – 1997 it constituted 1% of GDP. This level is consistent with the level of budget subsidies in the other transition states, even in EU states. So, they could not be regarded as a mechanism that has ensured soft budget constraints for the majority of companies in the state sector. They were strongly concentrated in a small number of public companies, mainly connected with certain branches and activities, such as railway transport, energy sector (heating plants and mining industries), certain forms of public catering, etc. Almost all-remaining activities, except for health care, education and government were not subsidised by the state.

One of the main ways to loosen the budget constraints on companies in transitional economies is by creating conditions for increase of their tax liabilities.

Data from the financial statements of the companies for FY 1996 show that tax liabilities of the companies (including liabilities to the National Insurance Institute) constituted 19,2% of GDP. This level has grown by almost 6 per cent points as compared to the year-end of 1995. If we assume that the level of tax liabilities to GDP was about 0% at the end of the functioning of the centrally planned economy (the end of 1989), we can calculate that in the period 1990–95 there was annually a cash flow from the state budget to the companies amounting to 2,5% of GDP. This means that the cash flow, which was due to the increase of tax liabilities, was higher than the cash flow from the state budget to the companies, resulting from direct state subsidies.

Tax liabilities accumulated by loss generating companies can be seen as a mechanism for loosening the strict budget constraints, while the tax liabilities accumulated by profitable companies are an indicator of the lack of financial discipline, weak tax authorities or lobbying for certain companies or activities.

Data for 1996 show that the concentration of tax liabilities was higher in the loss generating companies, while in the private sector higher concentration of tax liabilities was observed among the profitable companies. It turned out that delaying or even evading paying taxes was a successful strategy for the Bulgarian companies in this period. This is an indicator of the weakness of the tax system in the country, and of the total lack of fiscal discipline.

Data about the commercial loans, derived from the balance sheets of the companies, do not support a statement that suppliers have placed their clients in the conditions of soft budget constraints. The size of commercial lending in Bulgaria is not bigger than the one in the developed market economies, where it is common practice for suppliers to strive after expanding commercial credit for their clients. Since the trade laws in Bulgaria do not protect efficiently enough the creditors (incl. suppliers), their prudence in extending commercial loans is quite natural. We could expect therefore that suppliers would strive to place their clients under more rigid budget constraints in this country.

Even in cases where the companies may have imposed soft budget constraints for their clients, it was the Government rather than the individual companies that accounted for that. Directly or indirectly the Government tolerated delays in payment for gas supplies, oil products, coal, power supplies, etc. and this was possible due to the fact that almost all companies producing or supplying these goods are state-owned, even more – holding monopoly positions. Similar relieves were targeted primarily on other state companies in a financial crisis and the common explanation was that these are industries of a too great significance for the Bulgarian economy. It is necessary to put an end to this practice and the Government economic policy must be really unbiased to all companies suffering economic or financial difficulties, irrespective of their size, branch or type of ownership.

In order to assess whether the commercial banks in Bulgaria have secured soft budget constraints on the companies, it is necessary first of all to assess whether companies which cannot cover their operational costs have received net bank financing, measurable through the change in the face value of bank loans, from which interest payments are deducted. If the net bank lending for companies in the situation of an economic crisis turns out to be positive, then cash-flows have run from the commercial banks to the companies and they have been placed in the conditions of soft budget constraints. And vice versa, a negative net bank lending for loss generating companies will mean that commercial banks have imposed rigid rather than soft budget constraints on these companies.

Enterprises with negative operational income account for 24% of all companies that have received large bank loans (over 135 mil BGL as of the end of 1996). Broken down by sectors they are: about 18% of all public companies and about 30% of all private companies. The relative share of public companies with negative rate of return and positive bank financing is 78% of all public companies 88% respectively. It can be assumed that for a great portion of these companies the increase in the net bank financing is due to the depreciation of the national currency in 1996 if the loans extended to them by that time had been in foreign currency. With only 9% of all companies with negative rate of return (11 companies) the net bank financing has grown more than twice, and with 4 of them – more than 5 times. It is not justifiable to assume that with these latter companies the increase in the net bank financing was due exclusively to the depreciation of the national currency.

Commercial banks should be more willing to increase their lending for companies with positive profitability. Nevertheless, the relative share of companies with positive profitability and relatively large increment of the net bank financing is smaller than the one of companies with negative rate of return. This might be due either to the structure of loans already extended (both in BGL or forex) or to the reluctance of companies with a positive financial result to increase their bank loans, because of their high price when measured against the level of real interest rates on bank loans.

Data about public companies in 1998 show that in the first half of the year there was a tendency of loosening the budget constraints only on the part of the state budget for companies from this sector of the economy. As for suppliers and commercial banks, they strove for reducing their accounts receivable from these companies during the first half of 1998. The increase of the debt of the companies to the state budget and the National Insurance Institute identifies the state as a major economic agent loosening the financial discipline of the companies from the state sector. This is a symptomatic fact, which can be observed in many other states of Eastern Europe, whose governments are trying to rescue enterprises, which are in a bad or even hopeless financial condition.

Financing of the operational and capital improvement activities in the real sector is a problem of extreme importance for its growth.

The capital market and the corporate securities market have not been developed yet. Bank loans and own resources still remain the only source of funding available for the companies. Commercial banks are still reluctant to extend new loans because of the high risk related with the real sector in the country. Small and medium enterprises, most of which are newly set

up, find it even more difficult to reach access to bank loans. Different studies of the sector show that no more than 8% of the companies in this sector has ever had access to bank loans. Very few of the small and medium companies do apply for bank loans, even though the lack of financial resource is a major problem for their business development. The conditions for their granting are the main reason for this fact.

The issue of promotion of investment and restructuring of the economy is closely related to the issue of the functioning of the financial system in a way that would allow the companies to reach their optimal capital mix. Numerous studies have been conducted on this problem both in the developed market economies and in the countries of CEE.[3]

The regression analysis that was made is trying to establish whether the bank system in the country has performed successfully its functions of a financial mediator[4]. In all cases the signs before the multipliers of the independent variables are identical, which means that factor variables have influenced in one and the same way the dependent variable for both private and public companies in 1996 and 1997 as well.

The sign before the variable multiplier, characterising the profitability of the companies, is negative. One possible expla-

[3] The analysis contained herein is similar to the analysis in: *Corneli, Francesca, Richard Portes and Mark Schaffer* – "The Capital Structure of Firms in Central and Eastern Europe", Centre for Economic Policy Research, Discussion Paper No 1392, 1996, concerning the factors for bank lending for companies in Hungary and Poland.

[4] The independent variables of the regression analysis of the public companies are based on data for 1995. Due to the fact that we do not have data about income and expenses of private companies in 1995, the independent variables in this case have been computed based on data for 1996. As for 1997 we have not made two separate calculations for the two components of the real sector and have used the data for 1997. This is a deficiency of the model, because the behaviour of the commercial banks (lending) has probably been based on data of the companies for previous periods. That is why we verified the model for the public companies for 1996, by computing all independent variables with the data for 1996. The signs before the multipliers of the independent variables remained the same, while the statistic characteristics of the model were not degraded. If we assume that the situation with the model of the private companies for 1996 and for 1997 will be the same, then the signs before the independent variables will be the same like the ones that we have obtained when using data for 1996 instead of for 1995.

nation is that the negative multiplier in the implicit equation of the demand for credit has prevailed over the positive multiplier in the equation of supply of credit. As noted before, this was due to the asymmetric nature of available data, hence – to the high price of lending resource. Another possible explanation is that in this period the short-term state of the enterprises may not have been a good indicator of their future potential and the banks therefore did not use it as an indicator when assessing the creditworthiness of the companies. Still, the fact that more profitable companies have a smaller gearing/total assets' value ratio is a signal that the financial system has not provided the companies with the best conditions possible for reaching an optimal capital mix.

The sign before the multiplier of the ratio Non-current Tangible Assets/Total Assets is also negative. Various reasons may account for this. In this case we use the book value of the assets (of NCTA as well) derived from the annual financial statements of the enterprises, which might be well apart from their market price (higher or lower). Secondly, the bankers might see the capital-intensive branches, which typically have high values of this ratio, as branches with the worst prospects for future development. We checked additionally the correlation between profitability and the ratio NCTA/total assets and it turned out to be negative with both private and public companies. Therefore, if we still retain the assumption that profitability is positively related to the supply of credit resources, then the latter must be in a really negative correlation to the ratio NCTA/total assets.

The sign before the multiplier of the logarithm of sales is positive, but the multiplier itself is close to zero, which means that the relation between the size of the companies and their access to bank loans is not very clear, which is actually what we expected to find out.

It is also necessary to update the system of state standards and quality requirements for goods and services, so that they can match the requirements prevailing at the markets of major importance for Bulgarian exporters. It is also necessary to improve the quality assurance system to make sure that these standards are met. We do not mean that introducing new quality requirements, licenses, etc should unnecessarily increase state

bureaucracy. If these steps are undertaken, conditions will be created for introduction of foreign quality requirements even when realising the products at the domestic market. Presently the segment of low-income consumers, who give preference to the strategy – low prices for low quality, overwhelms the Bulgarian market. The presence of competitive imports does not allow the Bulgarian manufacturers to raise the prices of their goods and services directly, and they do this by degrading their quality. The end users are generally scattered and do not have the efficient demand needed to exert an impact on the producers and force them improve the quality of products. This function therefore, has to be taken over by a system of quality control over products. The strategy "low prices for low quality" might be successful for the Bulgarian manufacturers at the domestic market, but it reduces their export potential in the long run. What is more, such a strategy can be successful at the domestic market for a relatively short period of time, because it is quite easy to copy from foreign producers. In such a case the local producers usually start demanding protectionism against low-quality imported goods, against imports at dumping prices, etc., which is, in effect, a demand for protection against their own strategy, applied at the domestic market.

Table 1

Distribution of Sales and Labour Costs by Companies According to Their Profitability (% of all Sales and Labour Costs in the Respective Sector)

	Number of Companies in the Sample	Share in the Sales of the Sector	Share in the Labour Costs for the Sector
1996			
Public Companies			
EBIT[5]/assets≦ -10%	1673	4.3	8.9
–10%<EVIT/assets≦0%	2120	20.1	22.9
0%<EBIT/assets≦10%	2876	28.7	24.8
10%<EBIT/assets	2945	46.9	43.5

[5] EBIT – earnings before interest, taxes, etc. divided by total assets.

	Number of Companies in the Sample	Share in the Sales of the Sector	Share in the Labour Costs for the Sector
Private Companies			
EBIT/assets ≦ –10%	5583	5.1	11.7
–10%<EBIT/assets ≦ 0%	6253	17.9	26.6
0%<EBIT/assets ≦ 10%	12 219	45.0	32.1
10%<EBIT/assets	7554	32.0	29.5
1997			
Public Companies			
EBIT/assets ≦ –10%	593	8.1	12.0
–10%<EBIT/assets ≦ 0%	687	23.4	20.7
0%<EBIT/assets ≦ 10%	2009	40.9	35.0
10%<EBIT/assets	974	27.6	32.3
Private Companies			
EBIT/assets ≦ –10%	4764	2.0	5.0
–10%<EBIT/assets ≦ 0%	6478	12.0	12.3
0%<EBIT/assets≦ 10%	18 395	37.2	35.5
10%<EBIT/assets	8812	48.8	47.2

Data source: NIS, own calculations.

Table 2

Structure of the Expenses of the Companies

	1996	1997
Public Companies		
Material expenses (include, goods purchased from other enterprises)	77.9	66.5
Labour Costs	15.2	12.9
Depreciation	2.5	0.4
Other costs	4.4	20.2
Private Companies		
Material costs (include, goods purchased from other enterprises)	87.3	71.8
Labour costs	7.6	13.1
Depreciation	1.2	0.9
Other costs	3.9	14.2

Data source: NIS, own calculations.

Table 3

Level of Commercial Credit in Some OECD States and Transitional Economies (as of Year-end, % of GDP)

State	Year	Com. Credit (% of GDP)
Czech Republic	1994	49
Hungary	1993	24
Kazahstan	1996	25
Poland	1995	15
Russia	1996	27
Finland	1990	20
France	1990	38
Sweden	1990	21
Great Britain	1990	20
Bulgaria	1995	14
Bulgaria	1996	22
Bulgaria	1997	19

Data source: (Schaffer[6]). NIS, own calculations.

Table 4

Results of the Regression Model – Private Companies without Foreign Holding
Dependent Variable: Gearing/Assets 1996

Independent Variable	Multiplier	Standard Error	T
Constant	0.457	0.074	6.205
EBIT/assets 1996	–0.511	0.004	–126.689
Logarithm of sales 1996	0.028	0.008	3.460
NCTA/total assets 1996	–0.224	0.058	–3.836
Average value of dependent variable	0.6630		
R2 =	0.352		
Number of companies	29708		

Data source: NIS; own calculations.

[6]*Schaffer, Mark* – “Do Firms in Transition Economies Have Soft Budget Constraints? A Reconsideration of Concepts and Evidence”, CERT Discussion Paper 97/20, also in: Journal of Comparative Economics.

Table 5
Results of the Regression Model – Public Companies.
Dependent Variable: Gearing/Assets 1996

Independent Variable	Multiplier	Standard Error	T
Constant	0.354	0.028	12.428
EBIT/assets 1996	–0.738	0.025	–28.994
Logarithm of sales 1996	0.049	0.003	17.157
NCTA/total assets 1996	–0.657	0.021	–31.663
Average value of dependent variable	0.4637		
R2 =	0.197		
Number of companies	6826		

Data source: NIS, own calculations.

Table 6
Results of the Regression Model – Public and Private Companies.
Dependent Variable: Gearing/Assets 1997

Independent Variable	Multiplier	Standard Error	T
Constant	0.475981	0.012	41.37339
EBIT/assets 1996	–0.20238	0.005	–39.4086
Logarithm of sales 1996	0.015228	0.001	14.65685
NCTA/total assets 1996	–0.37786	0.007	–52.4864
Average value of dependent variable	0.485907		
R2 =	0.093576		
Number of companies	37 877		

Data source: NIS, own calculations.

COMMENT

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CASE, Warsaw

In my comments to the presentation of Mr. Lubomir Dimitrov I would like to focus on one segment of the real sector – on the privatised former state owned enterprises. My remarks are based on the findings of a survey. The survey was conducted in September and October last year. It involved interviews with 52 medium and large Bulgarian companies, privatised before the end of 1996. The purpose of the survey was to study the interdependencies between applied in Bulgaria approach to privatisation and its impact on the performance and the issues faced by the privatised enterprises.

A basic prerequisite for the privatisation of the state owned sector is the creation of the necessary conditions for increasing of economic efficiency and of the competitiveness of the privatised companies. The rich experience accumulated by a number of countries in transition proves that formal privatisation does not always lead to the expected results, especially for a short period of time.

The efficiency of privatisation, viewed as methods of restructuring, depends on a number of factors. In a great degree the legal and institutional framework for privatisation, applied methods, techniques and the procedures for transformation of ownership determine them. They must reflect the priorities in the policy of the economic reform. They also should create favourable conditions for the postprivatisation restructuring of the enterprises. It leads to structural changes in the economy and to economic growth.

The privatisation of the enterprises surveyed started as early as 1994. The privatisation of a specific enterprise may require a series of contracts because it aims at the usage of several techniques and offers for sale to several buyers. In 15 enterprises (29% of the sample) only one contract has been signed; in 13 enterprises (25% of the sample) – two contracts; 11(21%) – three contracts, and in 5 (10%) – five contracts. By the time of the investigation above 50 % of the shares have been sold in more than 90% of the joint-stock companies.

The transformation of ownership as a rule takes a long time (starting from the date of the decision for transformation till the date of the signing of the last transaction): 20 months in average. In half of the cases the transformation lasts more than a year and a half, in 15% of the cases – two or more years. In many of the companies private ownership starts to prevail typically after 13 months, and in half of the joint-stock companies – only after one year from the date of the decision, and in 15% of the cases – at least after two years.

In acquiring of the ownership of the objects to be privatised (fully or in large blocks of shares) often a buyer is obliged, in addition to paying the price, to take a number of obligations. The various kinds of obligations appeared in the process of privatisation of over 70% of the enterprises of the sample. This is possible due to the fact that in the process of privatisation of most of the enterprises the strategic investor is determined at the very first stage.

Findings suggest that the authorities responsible for the privatisation have tried to impose obligations to the investors always when it has been possible technically. Most often these obligations have been in the form of specific packets containing two or three, and sometimes four or five kinds of obligations.

Among all registered kinds of obligations the most frequently used one – and the most controversial because of its anti-market character – is restriction to change the previous profile of activity. The periods in which the profile of activity is supposed to be kept are usually rather long – over three and often even over five years.

On the second place are the social obligations, which concern nearly 2/3 of the investigated enterprises. The greatest attention is being paid to the workplaces. Eighty percent of the social obligations are connected with keeping up the present level of employment – in more of half of the cases for a long period of time – 5 or more years. Also in about 30% of the cases the investor obliges to provide social benefits in the form of free lunches, free medical care, etc. In about 40% of the cases the investor takes more than one social obligation.

The category of obligations whose expedience is least objected is on the third place. These are the obligations for investment. In the whole sample such obligations are present in 60% of the enterprises. The periods for realisation of the investments are long – in 2/3 of the cases they are as long as 5 years, the shortest of them being no more than three years.

In half of the investigated firms the strategic investors are obliged to pay the debts of the former state-owned enterprise. Such an obligation usually includes paying the greater part of the debt, and in 90% of the cases its full size. The obligation for the debts most often concerns the joint-stock companies whose strategic investors have been obliged to accept the whole packet of obligations.

At the end are the ecological obligations. These obligations are being realised only in every fourth company.

The analysis of the structure of ownership of the investigated enterprises makes possible to distinguish three features.

The first characteristic feature is the relatively low share participation *of* the insiders as new owners (at least in the investigated sample i.e. in the enterprises in a process of advanced stage of privatisation). The insiders, in spite of the alleviations for the present and former employees of the state-owned enterprises in the process of privatisation of "their own firm", are not the greatest category of shareholders.

The second characteristic feature is the slow changes in the structure of ownership after the privatisation. The reasons for the great inertia in the change of the ownership of the enterprises studied are the restrictions on the change of the property of 39% of the firms. These restrictions have been introduced in 1/3 of the enterprises transformed into joint-stock companies. In 63% of the investigated firms there is no turnover of shares.

The third characteristic feature in the structure of the property of the investigated enterprises is the high degree of concentration of property. In 69% of the firms there is a strategic investor who is the owner of more than 50% of the shares. In 32% of the firms the investor owns more than two thirds of the property which gives him full control. In the rest 21% of the firms the largest investor has no influence over the management because he owns less than 1/3 of the shares. In 87% of the joint-stock companies no more than three of the largest investors own the controlling blocks of shares.

As a result of the transformations in the investigated enterprises, four basic models of the structure of property have been formed. The first and most widespread one (55% of the firms) is with prevailing ownership of the domestic outsiders, of which 25% of the firms are investment funds, in 30% – the rest of the domestic legal entities. The second model includes the predominance of the insiders. The third model is with the prevailing participation of foreign investors (12%), the fourth one – without a prevailing participation of any of the owners (12%).

Table 1

Patterns of the Ownership Structure in the Surveyed Companies

Categories of Companies	Patterns of the Ownership Structure			
	Dispersed	Prevailance of Insiders	Prevailance from Domestic Outsiders	Prevailance of Foreign Investors
TOTAL	12	21	55	12
Methods of transformation				
1. Transformation into a joint-stock company	12	24	54	10
2. Transformation into a limited liability company	17	–	67	16
3. Sale without preliminary transformation (direct sale)	–	20	60	20
Techniques for privatisation				
1. Cash:	11	31	42	16
– workers'-management buy- out	6	56	25	13
– auction / tender	25	25	50	–
– negotiations with potential buyers	–	–	57	43
2. Bond	11	16	69	4
Sector				
1. Heavy industry and mechanical engineering	9	18	73	–
2. Elektrotechnical and electronic	–	–	33	67
3. Chemical	11	33	56	–
4. Clothing and textiles	15	31	46	8
5. Food processing industry	15	8	62	15
Profile of manufactured goods				
1. Investment	12	15	65	8
2. Consumer	12	29	46	13
Phase of manufacturing				
1. Raw-material, semi-part manufactured goods	10	20	70	–
2. Final goods	12	23	52	13
Employment				
1. Less than 300 persons	11	21	63	5
2. 300 – 1000 persons	–32	47	21	
3. More than 1000 persons	29	7	57	7

The simplest mechanism of adaptation used by the enterprises is connected with getting free from the unnecessary assets. It concerns the clearance sale both of the production and non-production assets. The process of getting free from the unnecessary production assets has finished only in every seventh or eight investigated enterprise. Only one of ten enterprises has got ridden of the unnecessary non-productive assets.

The undertaking of the next measures for restructuring does not exceed the limits of the elementary mechanisms for adaptation in the enterprise itself and are connected with relatively available potential. One of the ways is a substantial reduction of the general expenditures and raising the productivity of the available resources.

The greater part of the investigated enterprises are going to undertake concrete actions or are in a process of their implementation. There is ongoing the process of a considerable reduction of the general expenditures in nearly 2/3 of the enterprises, but has been finished only in one of six of them. A substantial reduction of the costs of raw materials has been completed in no more than 1/3 of them, and a considerable reduction of energy consumption – in less than half of them. The number of the enterprises in which a considerable reduction of the employment has been started is (17,3%) or those in which the reduction of the employment has finished are (26,9%), which is relatively high, having in mind that in about 80% of the cases the new owners, within the limits of the social contract, are obliged to keep the level of employment and even to create new jobs.

A more advanced are the concrete actions for restructuring, connected with the changes of the profile of activity, widening of the range of manufactured goods (offered services) or with the introduction of technological changes.

Seemingly the fact that most of the privatised enterprises have the previous profile of activity could be shocking. This is understandable because nearly ‰ of them have taken this obligation in their contracts. For this reason the enterprises do not have a choice for their profile of activity at least temporarily. The greater part of the enterprises has undertaken (more than 1/3) or completed (more than 1/4) concrete actions for widening the range of manufactured goods products. Technological changes have been undertaken or introduced in more than half of the enterprises.

The processes of restructuring related with the system of management of the privatised enterprises and the changes in the sphere of motivation are relatively in an advanced stage.

A relatively great number – nearly 2/3 of the enterprises – have undertaken or completed the changes in the organisational structure.

More advanced restructuring measures are connected with the reorientation of the privatised companies from traditional manufacturing oriented into market oriented. Two thirds of enterprises under investigation have started to develop a new marketing strategy, one fourth of them has it already done. Also every fourth of companies has completed investment programs.

Generally, the results of the survey indicate that the restructuring of the privatised enterprises is being made by their own efforts, by their conception, and mainly by their own resources. This most probably is related to the character of actions for restructuring. As we have already said, mostly only elementary and superficial procedures for restructuring, not requiring great investments or efforts, are being used.

This is partially confirmed by the analysis of the amount of the expenditures spent already and, according to the enterprises, necessary for the implementation of the restructuring programmes.

Table 2

Expenditures for Restructuring (thousand Leva)

Amount of the Average Annual Expenditures	Year					
	1995	1996	1997	1998	1999	2000
Amount of necessary funds	152 400	143 400	92 700	185 400	186 000	181 200
Realised investments	147 700	153 000	130 100	166 600	X	X
Number of enterprises of which have made investments for the year	6	8	20	22	13	13

First, during the first three analysed years, the average amount of investment obviously falls down. This is explained by the fact that after the payment of the prices for the acquiring of the firms their owners have no funds for the restructuring.

Secondly, the relatively small discrepancy between the amount of funds, considered as necessary, and those practically realised confirms the fact that the actions, connected with the restructuring, are undertaken and conform with the financial potential of the firm.

Third, compared to 1997 – 1998 is declining the number of the firms, which intend to continue the financing of the restructuring. At the same time the amount of funds, necessary for the further financing of the programs for restructuring, remains nearly at the level, reached in 1998.

The crucial issue is the availability of the sources for financing of the restructuring processes or rather their unavailability from the viewpoint of the enterprises.

Table 3

Sources of Financing of Restructuring programs (in % of the Companies)

Share in the Financing the Restructuring (%)	Sources of Financing			
	Own Financial Resources	External		
		Increase of Capital	Credits	Strategic Investor
0	30.8	92.3	82.7	90.4
up to 10	3.8	–	1.9	1.9
from 10.1 up to 20	5.8	3.8	5.8	–
from 20.1 up to 30	1.9	1.9	–	3.8
from 30.1 up to 40	–	–	–	–
from 40.1 up to 50	–	–	1.9	–
from 50.1 up to 60	1.9	–	–	–
from 60.1 up to 70	1.9	–	–	–
from 70.1 up to 80	5.8	–	3.8	1.9
from 80.1 up to 90	–	1.9	–	–
from 90.1 up to 99,9	–	–	–	–
100	48.1	–	3.8	1.9

Almost half of the investigated enterprises cover the expenses for restructuring fully by their own resources. Only in separate cases as a source of financing of the restructuring the increase of the capital of the joint-stock company is being used, at a low level at that. A little more frequently the funds for restructuring are related with attracting strategic investor. The tendency of taking credits for financing the programs is not greater. This source is being used by 17 % of the firms, but only 7% of them receive the necessary amount of credits.

The positive results of the privatisation of the Bulgarian enterprises include a high degree of concentration of the property, especially having in mind the fact that it has become as a rule due to the participation of outside investors. In this way the typical problems of transformation of property faced by many of the post communist countries are avoided.

The survey shows a number of issues, which should be solved in order to improve the process of privatisation and create favourable conditions for privatised companies.

The privatisation includes joint stock companies with restrictions for turnover of shares. It contradicts the very idea of the joint stock company. The restrictions hamper the concentration of the shares by the most effective investors and delay the process of the redistribution of the property rights and development of the securities market.

When selling of privatised property the state imposes on the investors a number of obligations. The greater part of these obligations does not correspond to the principals of market economy and burdening investors. This reduces the attractiveness of the privatised enterprises which leads to serious problems in finding of the strategic investor, has a negative influence on the price of the transactions, reduces the chances for privatisation of the enterprises which are in a difficult economic and financial situation.

The obligations imposed on the investors not only hamper but also sometimes make active strategies of restructuring impossible which results in a further delay of a real improvement of the performance of the privatised enterprises. That is why, where it is expedient, there must be a reduction of the obligations to the rational minimum; the investment obligation must have a priority and of the social ones only those connected with employment and sometimes with ecological obligation.

COMMENT

Krassimir Angarski

Economic Secretary to the President of the Republic of Bulgaria

You probably know, that Professor Georgi Petrov, who is going to make an intervention later, and myself have for so many years now defended the thesis that the only way to raise funds or increase the capital and labour supply in Bulgaria, is by reducing taxes. There was yet another opportunity last year and the year before, when many big investors tended to come to this country, when Bulgaria had its 15 minutes, as Prof. Jeffrey Sachs put it. At that time our administration, which was referred to, was not prepared to receive them and conclude the deals right away. So we saw the crises in Kossovo emerge, the crises in Russia grow acute, the global finance crises appear and thus missed our big chance. We have to make twice and three times bigger efforts now, but the big investors may still not come. I therefore, would not like to ignore the issue of the factors of economic growth.

I would not like to comment the report that tackled the issues of the real sector. I will just outline some of them, which seem to me to be of particular importance. There is a very accurate definition in the report that “Bulgarian production is in decline and is suffering from lack of competitiveness”. I would like to relate right now this issue to the issue of the exchange rate that has been subject to so much deliberations here. Associate professor Stoyan Alexandrov was right when stating in Borovets that whoever raises the question of the exchange rate would be immediately accused of speculating against the Board. It seems to me that there is no use of merely stating whether the rate is realistic or not, whether it is an obstacle or not. This exchange rate is not likely to persevere, as we heard it in the comments today, and as we know from other countries’ experience. Why should not then the competent bodies that conduct explorations make a detailed analysis on how this rate impacts agriculture and food industries for example, what an influence it has on their exports. Does it influence industrial production and other branches? So that we can say it clearly: there is no need to change the exchange rate during the next two or three years but not individual experts like myself to be accused of opposing the Board.

I would like to mention that together with three legal experts and many advisers from the banking sector, I was one of the team that drafted the two laws on the Currency Board. These laws as you can see it now are operating in a perfect manner. What raises my greatest concern in the report we just heard, is that, while discussing economic growth, we heard that there is a very big intercompany indebtedness, rather indebtedness of the companies to the state. Data provided by the Ministry of Finance show that this is in the range of one and a half billion DM as this figure applies only to state-owned and municipal companies. I am not talking about the private ones. Their debt to the state budget only amounts to over one billion DM. This is a huge amount and if that is so, what kind of growth could we possibly talk about?

Now I would like to share the good news that a task force has already been set up at the Center for Economic Development to work on this problem, because if it going to develop along the same lines as to date, we cannot expect any serious economic growth. What really scares me is the conclusion that was made that the state has undertaken no steps to resolve this problem, thus almost fostering its aggravation. There was something like that in the report.

What are the ideas of the task force, which was asked to provide positive ways of solving the problem?

One of the options is to use the approach applied some time ago to the banks. I do not mean to say that the so-called ZUNK bonds solution was very successful. Other states did it simultaneously – cleared the banks and enterprises of their bad debt together. In 1994 we applied it to the banking sector only. Despite this however, the lack of bank discipline and serious banking supervision brought about the bankruptcy of many banks, even though a Law on Settlement of Bad Debt was enforced. Such a development is not likely today, due to the Currency Board, or even if it takes place, this would be an exceptional case.

I would like to see something like that in the real sector. We cannot tolerate a situation when an enterprise has a debt to the state amounting to billions of leva and it is pretty clear that the debt will never be repaid. Take Bulgargas for example – one of the biggest debtors with 350 billion leva. And, in spite of this, the enterprise is still functioning, the wages are growing. There are lots of examples like this, and as I told you, a huge amount is at stake – 1 billion leva debt to the state budget, or a total of one and a half billion DM.

The second option that could be applied is to use different financial schemes. We used to call them triple transactions before. They are absolutely prohibited now on the grounds that these are not clean deals, but still when it comes to privatising an enterprise in the very short run, when there is a buyer, then opportunities should be sought for participation of the state. For example – by raising the capital or providing some kind of temporary assistance through the Reserve Fund for Restructuring.

The third option is by forming the market. The Task force supports this market approach. We suggest that a market of debt is established. Our politicians, the legislature however is much scared of this method. They are afraid that once the debt comes out on the market, the privatisation will come to an end. This fear must be overcome.

I would like to tell Professor Sachs that we do have sector policies, even though not very distinctly outlined. For the agricultural sector for example – we have provided a five-year tax vacation for the producers, but still the problems we are faced with in this sector are so numerous, that such a relief plays practically no role. Tourism was also quoted as an example. We had a big debate whether VAT should be levied on tourism or not. So the problems here come mainly from our advisers or the “supervisors” of the three-year program – IMF. We shall hear their opinion on this issue, but they have explicitly forbidden any tax relief. We have eliminated absolutely all relief for foreign investments. Illian Vassilev suffered a lot. I am in favour of policies that would allow us to attract capital, at whatever price, because Bulgaria does not have the capital that could step up economic growth.

THE PROTECTION OF PROPERTY RIGHTS AS ECONOMIC GROWTH FACTOR

Georgi Ganev

Center for Liberal Strategies, Sofia

I would like to emphasise the topic I am going to present to a certain extent in prospect, summarising Professor Sachs' presentation and then I will tell you a story. Prof. Sachs in general pointed out five basic recommendations for the achievement of economic growth in Bulgaria. I was particularly impressed by the prioritisation of these recommendations and in particular, by his giving high priority to the transaction costs. Transaction costs as a major issue for Bulgarian economy growth and the topic I am going to talk about, namely the property rights relate to that very question. He mentioned flows of funds and especially flows of funds to Bulgaria in the second place. Third he placed the need of investment in the material infrastructure, fourth – the development of sector networks that provide for the co-operation and interaction which are indispensable for the growth and development of competitiveness in the contemporary world.

In the fifth place Mr. Sachs ranked science and education.

Now, let me tell you a story, which I read in a book entitled "Ploughing the Sea". Some time ago Colombian leather bag manufacturers faced the following problem: their products did not sell, they were not competitive though they were considerably cheaper than, let's say Italian products. Therefore they asked a company to make a survey and to tell them what the reason for that situation was. The company followed the chain and they went to the North-American market and asked, "Why, in your opinion, do those products not sell?" "Well, indeed, they are three or four times cheaper but it seems that the quality of the leather is not good enough. Yet, they are designed for more wealthy people who would like to buy quality things" – was the reply of the buyers. Then they went to the Colombians exporters and asked, "Why do you export goods that are not of good quality although they are cheaper ones?" and the exporters' answer

was, "We get the best from Colombia but the manufacturers are those who do not give us products of better quality". Then they went to the manufacturers who sewed the bags and asked, "Why do you manufacture bad quality products?" And the manufacturers answered, "We do a perfect job – the sewing is OK, the design is excellent but the leather itself is not of very good quality". Then they went to the leather suppliers who said, "No, we do everything perfectly. The processing is in accordance with the latest technologies, it's perfect, but the problem is that the hide is of poor quality". Then they went to the hide suppliers who said, "We get it in that condition from the slaughtering house". They went the slaughtering house and were told the following, "No, it's not our fault. We get it from the cowboys". They went to the cowboys who said, "Oh, that problem? It's the cows' fault because they rub themselves against the trees". So following several months survey it was found out that the cows were to blame for it.

The moral of the story is that nobody will invest in an economy where the cows are to blame. All the factors listed by Prof. Sachs shall not have a positive effect in an economy where the cows are to blame. Nobody shall direct cash flows to an economy where the cows are the guilty ones. Nobody shall invest in an education and nobody shall care for an infrastructure because like the cows, like the infrastructure, let alone the establishment of sector networks because where it is the cows' fault, it is evident that nobody listens to and nobody cooperates with anyone else. So there is no interaction network to be talked about.

We go back to the first issue, the one relating to the transaction costs. I would say that we know the problem very well and we all heard in the morning what and how to do it. Why is it very closely related to the economic development issue? Because, in my opinion, and as Prof. Sachs mentioned, this issue comes ahead the others. We can list some 20 other factors for growth. The problem with transaction costs and hence the property rights problem are in the first place because we all talk about growth in the framework of a certain market environment and competition within the economy. Without any guarantees of property rights and without any developed patterns for the reduction of transactions costs there shall be no market and no competition. And it is useless to speak about any growth in an economy without a competition and a market.

Where is the problem itself? The problem is that it is well known and we all heard what and how to do this morning. It is very well known and I suppose the farmers also know very well what and how to do in order to produce good quality leather. The question we are still discussing in Bulgaria is not "what" and "how" but "who" and "why". Let me go back to a topic of this morning and this is the energy efficiency. Who and why would implement energy efficient technologies and would save energy, either a company or a household, if they can steal power? Why should they implement such technologies? If there are incentives to implement energy efficient technologies and to save power, this will bring results. However, if incentives are not introduced and even if the government bursts out more subsidies than necessary for that sector, then energy won't be saved and the specific energy consumption of the Bulgarian GNP won't drop. But once we have introduced incentives then we could say: "Yes, this sector is suitable for investments, here they could help somehow". But it is useless to discuss any investment programs before this has been implemented.

Now let's go to the issue of property rights. It relates to the opportunity of stealing or appropriating, if we are to use a euphemism. Another euphemism for this is the economic term "soft budget restrictions". At a time when an economy allows the mass existence of a number of economic entities that have had the opportunity of appropriating from others by not fulfilling their obligations for a long time, such an economy cannot be an economy of guaranteed property rights. The market and competition analysis there is performed based on totally different principles, not on the traditional ones, which we are used to applying from and according to the economics textbooks. And then, at a certain moment it turns out that the policy has become irrelevant, the political actions of the state authorities have become disconnected from the current processes, which are taking place in the real economy. Because the state authorities may adopt an excellent investment program which we shall hear in a moment about, they may adopt an excellent energy program and it is possible that all the monetary funds allocated for them will disappear in the unfathomable sands. And there shall be no result whatsoever.

The reason for that status is that the structure of property rights and in particular of their application in Bulgaria has not been ratified yet. Property rights are not protected yet. When an economic entity has receivables, it is not sure at all that it will settle them. Let alone the time it will take to get paid and the fact that in the meantime the circumstances might have changed. There are two basic elementary points without which economic growth is impossible. The first thing is the ability to anticipate terms and events, which means at least a kind of prediction of the future, and the second thing is the level of co-operation among the economic entities in the economy.

When property rights are not protected, forecasts are made for shorter periods of time – for 1, 2 or 3 months ahead, no longer. Nobody in Bulgaria can anticipate things two years ahead. There is no such an economic entity. The economic culture in Bulgaria is still based on the lack of co-operation, on the so called single hit i.e. two economic entities meet hoping never to meet again, they deceive each other, instead of co-operating with each other and establishing a good relationship in this way, one of those relationships that are so important for the creation of value generating networks. In Bulgaria there are value appropriating networks and probably I needn't convince anyone of it, but there are still very few value generating networks. The reason for that and I come back to the main subject again, is the lack of guarantees, the non-protection of the property rights.

I do not think I should further emphasise the importance of this topic, but let me make some recommendations. To my satisfaction the two recommendations I can make based on this analysis are identical to Prof. Sachs' recommendations and correspond to some of Minister Boshkov's views when he talked about the plans for the future. The first concerns the reform of the legal system. When I say reform of the legal system I mean the court of law, the investigation, the prosecution and of course the procedure acts rather than the substantive acts, both civil and penal acts that could make the jurisdiction, the implementations of regulations, the observance of rules, the performance of contracts predictable. Then, if an economic entity considers it necessary to sue another one, it will be able to predict how long it would take to have a court decision without being sure what the decision will be since the court may rule a decision that he or she has not expected. However, the point is about being able to anticipate things before someone concludes a transaction with another economic entity he or she does not know. It is good if he or she has confidence in the legal system according to which this transaction is being concluded because, otherwise, the transaction becomes too expensive and will most likely not be signed. And when there are no transactions, there is no specialisation, no networks, no market and no growth.

The second thing that can be formulated as a recommendation is the development of the education, because we are talking about the necessity of changing the economic culture of the whole country and this cannot be done without a proper education. Bulgaria must focus on the education and try at least not to prevent people from studying.

As a person who is trying to teach in Bulgaria at the moment and has graduated abroad I encounter serious difficulties.

People should not to be prevented from studying economy and other subjects that will develop culture based on the co-operation, creation of networks and long-term thinking and not culture of short-term thinking based on a single hit and appropriation.

Only when those two things are united together in Bulgaria, i.e. a system of property rights that are protected and applied plus an economic culture in the society that duly acknowledges the importance of the indispensability of co-operation which means sometimes sacrificing something or missing a good market opportunity in order to be able to co-operate with another economic entity, only then growth an be achieved. Without this any program of those that are to be discussed this afternoon shall work.

COMMENT

Paul Reynolds

Adam Smith Institute, London

It is very nice to back in Bulgaria, returning to a civilized country, after last place I was. It seems to me that it is a testimony to the achievement of the government over the last two years that the subject matter for debate is how we could get a double-digit growth in the economy. And the fact that the international financial institutions are assuming a positive growth rate for the country describes an extraordinary achievement.

The perspectives put on by Mr. Boshkov and Mr. Sachs is an excellent testimony to the achievement of the government, although the Bulgarian economy still lags significantly behind Poland, Czech Republic and Hungary. But it is catching up quickly. The two reformist governments elected roundabout the same time- one here, one in Romania-it is all pretty clear to everybody which one is doing better than the other, contrary to the popular expectations a couple of years ago.

In this presentation I will make some comments about an implicit question which may not have received a sufficient emphasis. And I will comment on one or two points of detail, which I don’t particularly agree with, given that this is a bit of a debate, the things that are not necessarily agreed upon are interesting for people.

The first point I want to make is on the role of government. In Bulgaria, I do not believe that the consensus on the role of government has reached a sufficient maturity in “Narodno Sabranie” and amongst the public generally. And the institutional question of reform is one which “dogs” that government and has made reform more difficult. The previous speakers quite rightly referred to questions like removing obstacles to reform and made reference to economic discipline. I would like to comment on this question of economic discipline, because it is often implied that if you have sound economic discipline then growth will come. I think this is not probably the case, it is certainly not the case in Bulgaria. A way to look at this question of economic discipline is to say that if the government has economic discipline in the economy-all it's doing is getting Bulgaria onto the playing field, so to speak. But you've still got to play and win the game. It really is a necessary condition but not a sufficient condition for economic growth.

There are other aspects of economic discipline. One of them is the currency board, about which there is much controversy. We at the Institute strongly support the currency board system. Secondly, disciplines in the macroeconomic sphere, in particular those from reforms to the enterprise sector of which privatization is one. This process has begun. Inflation has come down. But there is a negative side effect for growth prospects- that credit has squeezed substantially. It is not unreasonable because there was a free fall before this government came to power, and the pendulum has swung a little past equilibrium in order for discipline in the banking sector to be established very firmly. But there is a downside. These are the problem of try and play the game and win it, rather than just are on the playing field.

The currency board itself forces the government, should force the government to get the banks into the private sector, for the banks to rely on the profit motif, to ensure that credit is liberalized, and when credit is provided it is provided on economically rational basis. This means an increase in the number of banks in the sector; it means banks which are private; it means no longer monopolistic characteristics in the banking sector; a situation where small businesses and medium size businesses who have reasonable prospects for growth to be able to borrow money reasonably.

In Bulgaria we are a long way from that position. The financial discipline is there, the pendulum has swung, and necessarily it's what would happen. Now the government is faced with the need to normalize the banking sector and to develop a healthy functioning market in lending. The parallel is also in the microeconomic sector. If you have private ownership you have private enterprises and you have a system you've got to go and carry it through and implement those things which make you win the game, rather than just be on the playing field.

What I mean by that is the example with the energy sector with prices, which are still below a long-run marginal cost. It's

not enough simply to have prices above costs, because this is economic discipline, but it's not enough. The idea of having prices above costs is that it forces the government to do those, which are necessary. If you have prices above costs in Bulgarian energy, people know how inefficient energy is in this country. Having prices above the costs is only one half of the coin. The other half of the coin is that the costs come down, this means that the government is faced with the most difficult side of the coin, which is to address those things which those economic discipline things have made more painful. It seems to me that in this discussion that we've been having about growth we see the government still faces very difficult problems in dealing with these consequences of economic discipline.

In the microeconomic sector, in the enterprise sector there are still lamentable practices, which have been referred to by both in the presentation from CASE and by Prof. Jeffrey Sachs. Disclosure is a big problem in this country. Trying to find out about enterprises, trying to purchase equity in this country's enterprises is very difficult, and the disclosure. There are lots of enterprises, which do not submit proper accounts. And it's very difficult even to find out about the ownership structure of many enterprises in this country. It's partially because of the fact that there are still quite a large number of enterprises under state control. As this CASE presentation was telling us a moment ago, there are great difficulties with those enterprises which have been privatized through sale to insiders, who have not yet tried to take those reforms in order to become efficient. Much of economy is still under informal monopolistic arrangements, they require a concerted action by the government. These are my comments on the question of economic discipline both on the micro side and the macro side.

The other moment I want to talk about, related to this, are some of the measures the government is considering taking for the future-things, in my view, may well be ill-advised. One of them on the macro side is for the government to go down the route of quasi-guarantees in the banking sector in order to deal with this problem of the other side of the economic discipline coin. Some examples were cited from the USA of government guarantees in the mortgage sector. In the UK these practices are not prevalent and would be regarded by with horror by policy makers.

The second difficulty is that of tax reform, or tax holidays. Tax holidays have a very small limited effect. And our research across the world has proven this time and time again. It's done and just because it is a commonplace it doesn't mean to say that it is the right thing to do or it's effective. It's like a popular myth about these tax holidays.

The way to look at this is: What the government may do and offer are a number of things to encourage investment. And some of those things cost a lot of money, and some of those things don't. Providing improved infrastructures for investors cost a lot of money but the benefits it would accrue are substantial indeed. Developing international networks in the banking sector to allow transactions to be a lot easier has a beneficial effect. Similarly, improvements in corporate governance and disclosure, and in company law, company law is still a bit of a mess in Bulgaria- these things have very substantial benefits to investors.

Tax holidays, frankly, encourage short-term investment. And if you give a tax holiday to a large Japanese manufacturer, located in Bulgaria, it might make a difference over a five-year period, a period when they are not going to be showing significant profits in the first two or three years. A tax holiday on corporate income tax is not particularly attractive, but if it's offered it's usually taken. If a large Japanese manufacturer gets one or two million dollars in tax benefits in the first two or three years-is that really going to make a significant difference for an investment decision. Is the investment decision winded on if we've got a million-dollar benefit if we invest here, on a three or four hundred million investment? The investment is very fragile and it's not very effective. For the government, however it's very costly indeed. On the one hand, it's not a particularly big deal for a foreign investor to have a small tax concession at that time. But if you've got a government here with wide-spread tax arrears from the enterprise sector, and the government is trying to get financial discipline into its own budget efforts, the government is short of cash. That's clear and obvious. So when the government has a very important objective to pursue proper tax discipline in the economy then this idea of giving away tax holidays o people sends the wrong signals to society. In that sense a tax holiday has a very big cost on the economy and the cost in relation to the benefit of the investor is much too high.

Of course in many other countries they give away tax holidays. They don't have such a budget problem, the cost is may be not so high. But for Bulgaria it's not very appropriate. On those two points of disagreement on what has been said I will conclude and I wish the government well in its search for growth.

FISCAL POLICY AND ECONOMIC GROWTH

Marek Dabrovski

Vice President, CASE, Warsaw

Discussing the interrelations between fiscal policy and economic growth means touching the very fundamental question of the role of government in economic life of the country. This is strictly connected with the issue of quality and general philosophy of government involvement in economic management. Of course, it is a very broad theoretical topic going far beyond the agenda of my presentation. In addition, it constitutes a very hot political and ideological issue in any country. Certainly, it is not my task and my interest to be engaged in this kind of debate. Hence, I want to concentrate myself on three selected questions having a very practical importance in elaborating a macroeconomic strategy of any transition country, including Bulgaria. First, I will discuss the size of government, i.e. the share of expenditures and revenues to GDP, and its consequences for an economic growth. Second, the structure of government expenditures and revenues will be analysed. Third, I will comment the role of fiscal policy in determining macroeconomic stability. Finally, I will formulate some brief recommendations for Bulgaria. My remarks and conclusions will base mainly on a comparative experience of transition economies.

1. Excessive size of government in transition economies

Analysing the share of government expenditure in GDP, I will have in mind so-called general government, i.e. consolidated fiscal accounts of the central (federal) budget, regional and local budgets, and extra-budgetary funds and institutions of similar character (for example, public health insurance companies). However, general government concept does not include revenues and expenditures of public (i.e. state or municipally owned) enterprises, which are considered as a part of the private (business) sector. Only such a comprehensive approach allows for adequate assessment of the actual size of government and cross-country comparability.

Official fiscal statistics on the cash basis do not necessarily cover all the cases of fiscal activities and fiscal disequilibrium. This relates, for example, to debt restructuring of banks and enterprises by issuing special government bonds as it happened in Bulgaria, Hungary, Poland, and some other countries. It increases the size of public debt and future fiscal burden though it is not reflected in the current budget composed on the cash basis[1].

Apart from the officially recorded fiscal operations, central banks or commercial banks are sometimes involved in quasi-fiscal (QF) activities. This phenomenon was particularly frequently observed at the beginning of transition when central banks were still heavily dependent on government and parliament, most of commercial banks publicly owned, and fiscal accounting standards did not meet the international norms. Among the most frequently observed forms of the QF operations, one may distinguish loans granted by the central bank at subsidised interest rate, purchases and sales of foreign currencies under the system of multiple exchange rates, servicing public external debt by a central bank on behalf of government, netting out operation of inter-enterprise debt, and co-financing of public investment projects.

Despite numerous attempts to estimate the scale of quasi-fiscal operations in (*see* e.g. De Melo, Denizer and Gelb, 1996; Budina, 1997; Markiewicz, 1998) they will not be included to my analysis because I do not have a complete and comparable data. However, one can assume that in most transition economies this is already a history and QF operations either were totally terminated, or play the marginal role only.

Table 1 illustrates different level of fiscal redistribution of the GDP, i.e. different size of government among transition economies[2]. One can distinguish three groups of countries

[1] Markiewicz (1998) gives the extensive overview of different concepts and definitions of fiscal deficit.

[2] I decided to skip Belarus, Turkmenistan, and Tajikistan in table 2 because I doubted about comparability of fiscal indicators of these countries with rest of the sample (mainly because these countries continue large-scale quasi-fiscal operations).

Table 1

Revenues, Expenditures and General Government Balance in Transition Economies (in % of GDP)

Country	Indicator	1994	1995	1996	1997
	Central European and Baltic countries				
Croatia	Revenue	43.2	45.8	47.0	46.8
	Expenditure	41.8	46.7	47.4	48.2
	Balance	1.5	–0.9	–0.5	–1.4
Czech Rep.	Revenue	44.9	43.8	42.7	40.7
	Expenditure	46.0	45.7	43.9	42.8
	Balance	–1.2	–1.8	–1.2	–2.1
Estonia	Revenue	41.3	39.9	39.0	39.4
	Expenditure	39.9	41.1	40.5	37.0
	Balance	1.3	–1.2	–1.5	2.4
Hungary	Revenue	51.4	48.1	46.8	44.9
	Expenditure	59.7	53.2	49.9	49.5
	Balance	–8.3	–7.1	–3.1	–4.6
Latvia	Revenue	36.5	35.5	36.5	39.0
	Expenditure	40.5	38.8	37.8	37.6
	Balance	–4.0	–3.3	–1.3	1.4
Lithuania	Revenue	32.7	32.8	30.1	33.5
	Expenditure	37.5	37.3	34.7	35.4
	Balance	–4.8	–4.5	–4.6	–1.9
Macedonia	Revenue	51.0	45.3	44.3	42.4
	Expenditure	54.2	46.5	44.7	42.7
	Balance	–3.2	–1.3	–0.4	–0.3
Poland	Revenue	47.5	45.7	45.1	44.1
	Expenditure	49.5	48.4	47.5	45.8
	Balance	–2.0	–2.7	–2.5	–1.7
Slovakia	Revenue	46.4	47.1	46.9	41.5
	Expenditure	47.7	46.9	48.3	46.4
	Balance	–1.3	0.2	–1.3	–4.9
Slovenia	Revenue	45.9	45.7	45.2	45.0
	Expenditure	46.1	45.7	44.9	46.2
	Balance	–0.2	–0.0	0.3	–1.2
	CIS and Balkan countries				
Albania	Revenues	24.5	23.9	18.3	16.4
	Expenditures	31.2	30.8	29.0	28.4
	Balance	–7.0	–6.9	–10.7	–12.0
Armenia	Revenues	27.7	19.3	17.2	17.4
	Expenditures	44.1	30.4	26.5	24.1
	Balance	–16.4	–11.1	–9.3	–6.7
Azerbaijan	Revenues	24.5	15.0	16.2	17.4
	Expenditures	36.0	19.3	18.8	20.2
	Balance	–11.4	–4.3	–2.6	–2.8
Bulgaria	Revenues	39.9	36.6	34.3	31.5
	Expenditures	45.7	43.0	47.6	34.1
	Balance	–5.8	–6.4	–13.4	–2.6
Georgia	Revenues	7.7	7.1	9.4	10.4
	Expenditures	24.2	12.3	13.9	15.3
	Balance	–16.5	–5.3	–4.5	–5.0
Kazakhstan	Revenues	22.5	24.6	22.9	23.4
	Expenditures	29.6	26.8	25.9	27.1
	Balance	–7.1	–2.2	–3.0	–3.7
Kyrgyzstan	Revenues	20.8	16.7	17.1	17.6
	Expenditures	28.6	30.2	23.4	23.3
	Balance	–7.7	–13.5	–6.3	–5.7
Moldova	Revenues	33.5	33.9	32.1	34.3
	Expenditures	42.6	39.7	38.7	41.1
	Balance	–9.1	–5.8	–6.6	–6.8
Romania	Revenues	32.1	31.9	29.8	27.0
	Expenditures	33.9	34.5	33.7	31.5
	Balance	–1.8	–2.6	–3.9	–4.5
Russia	Revenues	34.6	31.9	32.1	33.0
	Expenditures	45.1	37.7	41.6	40.4
	Balance	–10.4	–5.8	–9.5	–7.5
Ukraine	Revenues	41.9	37.8	36.7	38.4
	Expenditures	50.6	42.7	39.9	44.0
	Balance	–8.7	–4.9	–3.2	–5.6
Uzbekistan	Revenues	32.3	34.6	34.2	30.2
	Expenditures	38.5	38.7	41.5	33.0
	Balance	–6.1	–4.1	–7.3	–2.8

Data source: WEO (1998), tables 17–19.

according to their general government expenditure to GDP ratio in 1997:

1. The group of high level spending countries (between 40 and 50% of GDP) which contains all the Central Europe – Hungary, Croatia, Slovenia, Slovakia, Poland, Macedonia, and the Czech Republic, plus Ukraine, Russia, Belarus[3] and Moldova among the CIS group.

1. The group of medium level spending countries (between 30 and 40% of GDP) which contains three Baltic countries (Estonia, Latvia, and Lithuania), Bulgaria[4], Romania,

[3] In 1997 general government expenditure to GDP ratio in Belarus amounted to 42.1% (WEO, 1998, table 19).

[4] From 1997 only. Earlier Bulgaria belonged to the high spending group.

Mongolia[5] and Uzbekistan.

1. The group of low level spending countries (below 30% of GDP) which contains all remaining CIS countries of Central Asia, Caucasus, and Albania. Tajikistan and Georgia represent extremely low level of public spending amounting to ca. 15% of GDP.

According to the so-called Wagner law, the level of fiscal redistribution is determined, to certain extent, by the level of country development. The share of general government expenditure in GDP is increasing with the higher GDP per capita level. However, even a very superficial insight into above grouping shows us cases of evidently low-income countries (Macedonia, Moldova) belonging to the highest spending category.

So high level of fiscal redistribution can be observed in Scandinavia and some other Western European countries only, but this group of countries represents much higher GDP per capita, even in comparison with the most developed group of transition economies, i.e. the Central European group. When Western European countries represented the same level of economic development as Central Europe now (some 30 years ago) their general government expenditure to GDP ratio did not exceed 30–35%. Similar (or even lower) level of fiscal redistribution can be observed now in Latin America representing GDP per capita level close to the Central Europe.

The high share of government expenditure in GDP will not stimulate the economic growth in the long perspective as it reduces the rate of private saving available for the investment financing. This effect is particularly adverse in transition economies where the rate of saving is rather low and budget is strongly dominated by consumption oriented expenditures (see next section).

High tax rates necessary to finance so large public expenditures[6] hamper the private business activity and stimulate its outflow abroad (or to the zone of shadow economy). In effect, high taxes lead to the so-called Laffer's curve effect, i.e. erosion of the tax base. High social spending usually discourages the interest in legal employment and distorts the labour market.

High government expenditure and revenues create also temptation towards a discretionary fiscal redistribution. This, in turn, leads to distortions in resource allocation, tax evasion, intensive rent seeking, corruption, etc.

Finally, microeconomic effectiveness of government spending is generally lower than private spending. This relates both to consumption and investment expenditures.

Comparative analyses [e.g. Sachs & Warner, 1996] give an excellent evidence that very high rates of economic growth in the South East Asia (higher than in other geographic regions) have their roots, among others, in small government. On the other hand, Western European countries representing typical pattern of the welfare state experience serious problems with continuing even very moderate rate of economic growth. This was a reason why Scandinavian countries (particularly Sweden) had to reduce their welfare state in the end of 1980s and in 1990s. Now the core EU countries – France, Germany, Italy, and Spain, face the same challenge.

The level of fiscal redistribution in second and third group of countries is much lower than in the first group and represents downward trend in most cases. However, apart from the Baltic countries, it is hard to say that this tendency results from the conscious political choice (like in the case of Estonia). Dramatic decline of revenues caused by numerous shortcomings of the tax collection and tax administration and unsatisfactory work of other government administrative institutions can be seen as the main reason of this spontaneous decrease of the fiscal redistribution (see Dabrovski, 1998).

2. Structure of government expenditures and revenues

Structure of public expenditures is strictly connected with the concrete role of government in economic life. The recommendation to avoid excessive size of public expenditures (see section 1) means a necessity to concentrate them on these activities

[5] In 1997 general government expenditure to GDP ratio in Mongolia amounted to 38.0% (WEO, 1998, table 19).

[6] I assume that high expenditure level must be eventually financed by taxpayers. If country runs a fiscal deficit (see section 3 of this paper), the latter will have to be covered either by the inflation tax (immediately or with certain time lag), or by higher tax burden in future (necessary to finance public debt service).

where government is irreplaceable by a private sector or has a clear comparative advantage. They are mostly connected with providing basic public goods.

Three priorities should be mentioned in the case of transition economies:

Providing the classical public goods such as public security, justice administration, law and contract enforcement, protection of private property rights, regulation of financial markets, etc. These activities are usually publicly financed and publicly provided. They are of fundamental importance for guaranteeing safety and stability of private sector's economic activity and creating a good investment climate. Most of post-communist countries experience fundamental difficulties with financing and providing this kind of public services. It is strictly connected with phenomenon of big but weak and ineffective state.

Human capital investments. In the contemporary world basic education is publicly financed but may be at least partly privately provided. Most of transition countries represent a rather fair level of public education expenditures but their effectiveness (and quality of provided services) is rather low.

Part of infrastructure investment such as public roads, which are publicly financed but can be built or even operated by private enterprises on the basis of public tender. In most of transition economies budget expenditures for this purpose (in relation to GDP) are very low comparing to developed countries and enormous investment needs.

Overly generous social programs, particularly pension systems are responsible for general over-expansion of government expenditures in transition countries and crowding out the above mentioned priorities. Table 2 shows a very high level of social security transfers in Central Europe and Baltic region. According to these data, only Lithuania could avoid the trap of `post-communist welfare state'. Table 3 contains data on public pension expenditures representing a main component of the social transfers. This statistics shows that the problem of excessive social spending relates not only to the most developed transition economies but also the less developed ones. The level of pension expenditures in Belarus, Ukraine, Moldova, Kyrgyzstan, and Uzbekistan is evidently higher than fiscal capacities of these

countries. This means that other important spending items such as infrastructure investments or education programs must be sacrificed in order to maintain such a high level of pension transfers.

Table 2

Social Security Transfers in Selected Transition Countries, 1996 (in % of GDP)

Country	Social Transfers (in % of GDP)
Croatia	13.5
Czech Republic	12.2
Estonia	11.0
Hungary	14.4
Latvia	16.1
Lithuania	8.8
Poland	20.8
Slovakia	14.5
Slovenia	20.2

Data source: WEO (1998), p. 112, table 24.

Unfavourable demographic trends force many governments, for example in Western Europe and in the US, to carry out pension and other social reforms. The same necessity exists in transition countries where demographic structure of population will gradually deteriorate.

What concerns the structure of government revenues, and construction of the individual tax instruments, solutions friendly for economic growth stay very often in conflict with the so-called social justice or fairness. The latter is often interpreted in a very egalitarian way, i.e., that tax system should take into consideration differences in income and wealth status of taxpayers. This usually leads to a progressive scale of direct taxation, and to preferences and exemptions in indirect taxation related to so-called basic goods and services. However, this would be in conflict with postulates of tax neutrality, simplicity, and its fiscal effectiveness, which are of crucial importance from the point of view of support for economic growth and fighting a shadow economy.

Historical experience shows that the lump sum tax, i.e. fixed

Table 3
Public Pension Expenditures in Transition Countries, 1996 (in % of GDP)

Country	Pension Expenditures (in % of GDP)
Central and Eastern Europe	
Albania	6.8
Bulgaria	9.5
Croatia	10.2
Czech Republic	8.4
Hungary	9.7
FYR Macedonia	11.2
Poland	14.4
Romania	5.8
Slovakia	8.3
Former Soviet Union	
Armenia	3.1
Azerbaijan	2.5
Belarus	8.4
Estonia	7.6
Georgia	1.7
Kazakhstan	5.3
Kyrgyzstan	7.7
Latvia	10.8
Lithuania	6.2
Moldova	8.1
Russia	4.5
Tajikistan	3.0
Ukraine	8.7
Uzbekistan	6.4

Data source: WEO (1998), p. 115, box 10.

amount paid by each citizen independently of his/her income and wealth status is this kind of instrument, which guarantees the maximal allocative neutrality, the simplest and cheapest administration, and allows to solve the problem of tax avoidance. However, relying on this kind of taxation would be economically realistic only in the case of very low government spending to GDP ratio (probably ca. 10%). Additionally, this kind of taxation usually raises a lot of political resistance on the ground that it does not take into consideration any differences in taxpayers income and wealth status. It makes difficult to introduce such taxation even as one of many instruments, as Margaret

Thatcher's experiment with local poll tax showed.

Broadly based indirect, multi-stage taxation (VAT) can be seen as the next best solution from the point of view of allocative neutrality and revenue collection capacity [see Neneman, 1999]. In addition, a well-constructed VAT allows taxing, to certain extent, a shadow economy. This is probably a reason why the VAT constitutes a basic foundation of contemporary tax system in all industrialised countries apart from the US, and in many developing countries. However, VAT is not an easy instrument to be administered and its good implementation usually needs a relatively long period of preparation.

Retail sale tax (RTS) is much simpler and cheaper in administrative operation, especially in federal country (the example of the US). However, it creates more allocative problems because the same goods can bought both as consumer goods and as investment or intermediary goods. Additionally, the absence of tax refund mechanism (which exists in VAT) eliminates the interest of enterprises to buy intermediary or investment goods from legal sources and therefore gives more opportunity for tax avoidance. Sale tax can also become much easier target for lobbing pressure in order to get preferential tax rates for certain goods and services.

Direct taxation creates much more motivation problems because this is in fact a kind of penalty for getting profit or other sort of income. If such taxation is high and its scale is progressive, tax avoidance becomes prevailing and tax administration extremely complicated. The same can be said about payroll taxes traditionally providing money for public pension and unemployment taxation. This works in similar way as proportional income taxation and if tax rate is too high it can push a part of business activity and employment into the informal sector.

However, in the economic and political realities of the contemporary world direct taxation and social insurance contribution are hardly avoidable. The practical choice is limited to their size and simplicity. More rates, and more exemptions has the tax system, it is more distortive, more complicated is its administration, and taxpayers have more incentives to avoid tax obligations. This rule also relates to indirect taxation.

The presence of many tax exemptions usually reflects weak government position and intensive rent seeking of different lobbies. Of course, these lobbies always use argument of public interest or protecting poor. However, constructing well-targeted tax exemptions addressing exactly the declared social problem is extremely difficult in practice. Exemptions in direct taxes are used mainly by high- and middle-income groups and not by the poorest ones (this is, for example, with housing tax exemptions in Poland). What concerns similar preferences in indirect taxation the potential mistargeting and revenue losses may be even greater (*see* Neneman, 1999). Social assistance for poor people should be carried out through system of direct well-addressed subsidies rather than through tax instruments. Low and uniform tax rates are much better from the point of view of tax neutrality and simplicity, and therefore, more supportive to economic growth.

Countries in transition did not have any great choice in designing general institutional frameworks of their tax system. They had to rely on the experience of developed Western countries, particularly that of the EU countries. It was determined by the necessity to have the basic institutions compatible with those existing in main trade and investment partners. In the case of Central and East European and Baltic countries, the strategic goal to join the EU played an additional, very important role.

3. Fiscal policy and macroeconomic stability

When country is unable to secure fiscal balance, the additional impediments to economic growth do occur. Fiscal deficit is connected with several negative macroeconomic consequences.

Financing fiscal deficit means absorption of private savings. Assuming other things being equal, it must lead to either decreasing investment activity, or to worsening current account balance (as the latter reflects investment-saving imbalance). Interest payments crowd out other expenditure items, worsening the structure of government expenditure.

When fiscal deficit is financed by a central bank credit it results in increasing monetary base (reserve money) and, assuming unchanged money multiplier, in proportional increase in broad money supply. Eventual inflationary effect depends on a size of deficit financing, money multiplier, and demand for money (monetary level). Higher is the deficit financed from monetary emission and lower is the monetary level, stronger are the inflationary consequences of fiscal disequilibrium (other things being equal).

In most countries the role of central bank direct credit to government was predominant during first years of transition when other sources of deficit financing, particularly T-bills market were not available yet. In fact, it was the most important factor staying behind initial high inflation/hyperinflation episodes in most of transition countries, apart from unfreezing accumulated monetary overhang (see Antczak, 1998).

As the markets of treasury bills had developed, the scale of monetary financing of fiscal deficits diminished. For instance, in 1993, the National Bank of Bulgaria credit covered 32% of a fiscal deficit, in 1994 – 26%, in 1995 – zero, but in 1996 – when macroeconomic situation deteriorated – the NBB again financed over 50% of the budget deficit (Markiewicz, 1998). According to IMF (1998, table 5) data the size of NBB credit to government reached 14.5% of GDP in 1996. Returning to the central bank crediting of fiscal deficit could be observed also in Russia and Ukraine in 1998 when market demand for government T-bills failed dramatically as result of credibility crisis.

Switching to the so-called non-inflationary deficit financing, i.e. issuing T-bills, Eurobonds, or other borrowing on commercial terms can in fact relax inflationary pressure only temporarily. Massive domestic and external borrowing can solve fiscal problems and support macroeconomic stability in short run only. Increasing debt overhang (the pace of debt accumulation is particularly fast under continuos decline of GDP) leads to explosion of interest payments and can bring very easy the situation of the debt trap and liquidity crisis of the government finances.

A relatively short history of economic transition can already give a number of striking examples of government liquidity problems and devaluation crises caused by excessive fiscal deficits: Hungary in 1994–1995, Kyrgyzstan in 1996, Romania in 1996–1997, Bulgaria in the end of 1996, Russia and Ukraine in the second half of 1998 (*see* Markiewicz, 1998).

Bulgaria's crisis of 1996–1997 resulted from slow and inconsequent structural reforms, weak fiscal and monetary policies, and the very high domestic and foreign debt exceeding the level of 100% of GDP. Massive bailing out of the loss making enterprises and banks became the substitute of privatisation and restructuring based on hard budget constraints. It put a new debt burden on the government finances in addition to the old debt inherited from the communist period bringing the Bulgarian economy to the situation of a real debt trap.

The lack of financial discipline also led to banking crisis in the beginning of 1996 that overlapped with an overall macroeconomic destabilisation. Premature attempts to decrease interest rate by the NBB in the end of 1995 (in order to relax the interest payments burden) became a detonator of the serious crisis and finally bring results completely opposite to the expected ones. Decreasing interest rates provoked chain reaction: decline in demand for leva, capital outflow, foreign exchange market crisis, dramatic collapse of the exchange rate of leva, inflation shock and further decline in demand for leva. NBB effort to stop this spiral by increasing interest rates came too late and was insufficient in scale. However, it brings the dramatic increase of interest payments: in 1996 they reached the level of 20% of GDP (!) while the total tax revenue amounted to 25.5% of GDP. Fiscal deficit amounted to 13.4% of GDP, despite the drastic reduction of all expenditure items apart from interest payments.

Russian and Ukrainian developments two years later look very similar to the Bulgarian ones. Series of Asian crises in 1997 reduced drastically the availability of relatively cheap external financing for emerging markets. Reacting on changing international atmosphere and signs of domestic political and fiscal instability non-resident investors decided to withdraw their holdings from the T-bills markets of both countries. It brought immediately two kinds of problems: liquidity crisis of the government, and pressure for the official foreign exchange reserves. The next step was the speculation of both non-residents and residents against the exchange rate, which constituted the only real stabilisation anchor. Attempts to defend exchange rate were very costly in terms of lost foreign reserves and high interest rates but did not stop the speculation and only drastically increased the interest payments. Central banks had to come back to a fiscal

deficit financing, mainly through rolling over the existing stock of T-bills. This caused the further erosion of the exchange rate.

Finally, devaluation became unavoidable. Devaluation led to the new wave of inflation, banking crisis (especially serious in Russia), further explosion of interest payments, shift from domestic currency to foreign currencies, and capital outflow. Default of the Russian government on the T-bills market and 90 days moratorium on repayment of Russian commercial bank liabilities finally undermined the country credibility among investors. Ukrainian crisis although a little bit less severe than the Russian one brought very similar consequences (see Dabrovski at al., 1999).

As result of Russian and Ukrainian crises, other CIS countries experiencing problems with persistent fiscal disequilibrium became in the end of 1998 subjects of speculative attacks of both domestic and foreign investors. This relates, among others, to Belarus, Moldova, Kyrgyzstan, Kazakhstan, Armenia, and Georgia. Transition countries having stronger fiscal and macroeconomic fundamentals, i.e. most of Central European and Baltic countries could avoid adverse contagion effect.

The above empirical examples clearly show that non-monetary financing of fiscal deficit can be also inflationary though with a certain time lag.

4. Recommendations for Bulgaria

Experiencing a very dramatic financial crisis of 1996–1997 Bulgarian authorities turned to radical measures in the sphere of monetary and fiscal policies. From July 1, 1997 the currency board regime was introduced. In 1998, country achieved fiscal surplus and the debt to GDP ratio went down significantly. As result, end-of-year CPI inflation amounted to 1% in 1998. Real GDP increased by 4% in 1998. Continuing such a policy is the most important recommendation for Bulgaria. Any public discussion about abandoning the currency board regime can only again damage the country's credibility. The only exit from the currency board leads through the EMU membership in the future. Currency board will be a sustainable solution in the long run if a fiscal policy continues to follow a tough stance of 1998. It will be possible if structural and institutional reform progress in much faster pace than it has been so far.

Financial crisis brought down both general government reenues and expenditures. Government of Bulgaria must resist a pressure to increase public spending again. It should also try to restructure budget expenditures in order to create more room for financing investments in basic technical infrastructure and human capital. It means the necessity to continue reforms of social spending, particularly of the pension system.

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THE INVESTMENT PROGRAMME OF THE BULGARIAN GOVERNMENT

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It was for the first time, since 1990, that in the Republic of Bulgaria a UDF Government took political responsibility for developing a public sector Mid-term Investment Program. It covers the period of 1998 through 2001.

The Program is a tangible result from the positive progress made in creation of a favourable macro-economic environment to activate the investment market.

• Economic stability has been achieved as a result of accelerated economic reform in key sectors of the enterprise economy. Expected GDP for the next three-year period is 3.5 – 4 %.

• By implementing the Currency Board System the main objective of the Bulgarian National Bank (BNB) is to maintain the stability of the national currency. It is achieved by a fixed Bulgarian lev-German mark exchange rate of 1000:1.

• The implemented monetary and fiscal policies restored confidence in the national currency, led to lower inflation rates (1% monthly), stable prices, lower interest rates and smaller budget deficit.

• The Bulgarian Government maintains a balanced budget, based on the guaranteed stability of its revenue part.

• The foreign trade balances of the country are being stabilised through developing and undertaking activities to encourage and enlarge the export, reduce the trade balance and the current accounts deficit to rates that do not endanger the stability of the Currency Board.

• Mid-term agreements with the international financial institutions have been achieved for the foreign financing of the country.

• The three-year Agreement with IMF, concluded on 25th of September 1998, which guarantees a significant backup for the balance of payment in a period of important structural changes in the Bulgarian economy, is an important factor for the economic development.

• The achieved investment growth in 1998 is an important condition for the development of the economy. The lower interest rate and the consistent measures taken to liberalise the domestic and foreign trade facilitate the growth mechanism, based on investment demand.

• Financial support is provided for the implementation of the country's strategic investment in the public and enterprise sectors through EU subsidies and loan agreements with international financial institutions — EIB, EBRD, World Bank, Export Credit Agency, Kuwait Fund for AEU, Japanese Overseas Co-operation Fund and others.

1998 — 2001 INVESTMENT PROGRAM

Given our belief in the extreme importance of investment for the economic growth and stimulation of development in other areas of social and economic life in the country, the Government of the Republic of Bulgaria over the next three years, will strive at the achievement of the following basic goals:

• Revival of the economic growth and creation of prerequisites for sustainable development.

• Acceleration of the national economy's restructuring in compliance with the adopted strategy for economic development of the country under market conditions.

• The country's integration within the European space through priority investment in infrastructure projects, which are part of the trans-European network of transport corridors, equipment and systems.

• Transformation of the Republic of Bulgaria into an important transport and energy juncture in South-eastern Europe and on the Balkans.

• Preparation of Bulgaria for an equal partnership and participation in the European integration processes.

• Balanced allocation and reasonable concentration of public finance.

Following the basic goals, the Program takes into account the additional factors that have an impact on the identification of investment priorities. These are:

• Geo-strategic location of the Republic of Bulgaria in Europe, on the Balkan Peninsular and within the Black Sea Region.

• The decisions taken by the EU Ministers of Transport for building infrastructure corridors crossing the territory of the Republic of Bulgaria, including:

A) Transport Corridor No 8, connecting the Adriatic Sea with the Black Sea in the destination of Duras–Tirana–Skopie–Sofia–Plovdiv–Burgas–Varna. It is an important factor for enlarging the processes of integration in South–eastern Europe and making it a peace and stability zone;

B) Transport Corridor No 4, connecting Western Europe with Asia–with several destinations – Dresden/Nurenberg–Prague–Vienna/Bratislava–Gur–Budapest–Arad–Konstanza/Krajova–Sofia–Thessaloniki/Plovdiv–Istanbul;

C) Transport Corridor No 9, connecting Northern Europe with Southern Europe in the destination of Helsinki–Saint Petersburg–Moscow/Pskov–Kiev–Lyubasevska–Kishinev–Bucharest–Dimitrovgrad–Alexandropoulus/Istanbul;

D) Transport Corridor № 7 – the River Danube destination.

The national investment program includes projects of investors that operate in the public sector — ministries, committees, agencies, municipalities, large economic organisations with prevailing state interest such as the National Electrical Company (NEC), the Bulgarian Telecommunication Company (BTC), the Bulgarian Railroad Company (BRC) and others.

The basic criteria for project selection are:

• Facilities of inter-regional, regional and national importance that are relevant to the development strategy and policy of the country and the region of South-eastern Europe;

• Contribution to the economic capacity growth and acceleration of the country's economic growth;

• Regional socio-economic and environmental relevance of the investment projects;

• Guaranteed complementary financing (co-financing) of projects, included in international programs, of which foreign financial aid agreements have been concluded;

• Opportunities to create alternative employment;

• Level of project readiness;

• Administrative capacity for reclaiming of investment and the its efficient management.

The total figure of planned investment in the private and the public sectors for the period of 1998 through 2001 is USD 9,754.9 m.

The planned investments in the public sector — total for the period of 1998 through 2001 —amount to USD 3,948 m as broken down by financial sources:

• From the consolidated state budget —(republican budget, off-budget funds, own budget resources and own off-budget resources for the major investors — ministries, related institutions, regions and municipalities, capital transfers with the exception of the railroads) – USD 1,339 m;

• From the resources of the state-owned economic organisations (own resources, state-guaranteed loans and company loans) — USD 2,609 m, incl. USD 1,049 m of own resources, USD 1,302 m state-guaranteed loans and USD 247 m company loans. These are mainly facilities within NEC, BRC, BTC, large infrastructure facilities like Sofia Airport, Air Traffic Control, transit roads — 2 and 3, rehabilitation of the railroads, restructuring of the water facilities, expansion of Port Burgas, etc.

• Additional reserves to encourage investment activities in the public sector: projects envisioned for concession contracting with initially planned investment at the amount of USD 1,324 m;

• Projects that will be financed on the basis of bilateral agreements, through grants from bilateral intergovernmental agreements with The Kingdom of Denmark, the Confederation of Switzerland and the American Agency for Trade and Development, and the European Union.

By the year 2001 Bulgaria will have a larger access to the European funds. That will build additional capacities of financing investment projects in the areas of technical infrastructure, environment and others, relevant to the criteria and requirements of the European institutions, under the programs like PHARE Transborder Co-operation, Pre-accession Funds, Large – scale Infrastructure, ISPA.

While entering the stage of EU pre-structure accession several budget directions are being outlined that are also directed to the sectors of agriculture and cultural identity — programs like SAPARD, Rafael and World Foundation for Cultural Monuments.

MAJOR INVESTMENT PROJECTS

The key position in the government investment program is occupied by projects in the technical infrastructure – telecommunications, roads, transportation and energy sector.

Telecommunications sector

By enacting the Law on Telecommunications the legal prerequisites for liberalisation of telecommunication activities and services are established and for equality between all operators. This policy proved successful in promoting greater investment activity in the sector, which started developing on the basis of market principles.

The telecommunications sector is of great importance for the national economy and for the expansion of the integration processes. Therefore an extensive program is being implemented there. It includes the following:

• Privatisation of the national telecommunications operator – BTC Co.

• Final completion of sites under the project DON (digital network) at the total amount of USD 260 m, funded jointly by international banking institutions and BTC. Within this project the following has been constructed:

a) new international telephone-exchange unit in Sofia;

b) Ground satellite station, oriented to a satellite over the Atlantic;

c) Optical cable tracks leading to the borders with Turkey, Romania, Macedonia and Serbia;

d) Submarine optical cable in the Black Sea (CAFOS project) funded jointly by BTC and the communications agencies of Romania and Turkey.

Roads and Water Supply Sectors

• Major projects:

a) Rehabilitation of existing road sections with a total length of 600 km, construction of a new motor way 32 km long. The implementation of the program will finish by the end of this year.

• Program “Transit Roads – 2” which is underway with the financial support provided by the PHARE (grant to the amount of USD 31 m) and a loan extended by EIB;

• Implementation of the program “Transit Roads – 3” which will involve rehabilitation of 600 km. of the first class road network, to be financed by EIB (loan agreement signed for USD 60 m) grants to be provided through the PHARE program (USD 30 m)

b) program for granting concessions to road infrastructure facilities

Major projects:

• Repair and reconstruction of road E-79 in the section Sofia-Kulata – part of trans-European corridor № 4.

The implementation of the project will reduce journey time by approximately 30 min. and will improve safety on the road.

• Construction of a section of motor way Maritsa – in the direction Orizovo–Kapitan Andreevo (road E-80) – Bulgaria–Turkey border – trans-European corridor № 8

A structural element of trans-European corridor № 4. Total length – 108 km.

• Completion of motor way Trakia in the direction Orizovo–Vetren, part of trans-European corridor № 8 (destination the Black Sea). A feasibility study has started with the support of the PHARE program. The national investment program envisages the process of concession contracting to begin in 1999.

• Rehabilitation and reconstruction of road E-79 in the section between Bulgarian–Romanian border – Sofia.

• Construction of motor way Black Sea in the section Vetren–Priseltsy, part of trans-European corridor № 8 connecting the two biggest Bulgarian ports Varna and Burgas.

• Rehabilitation and reconstruction of section Kalotina – Sofia – part of international road E-80, connecting Northern Europe with Asia (via Turkey).

In the Water Supply sector, the Government program envisages:

• Completion, as a priority task, of the water treatment plants and the construction of the main water supply systems. A main priority will be to secure the purity of Transborder rivers and improvement of quality standards of drinking water.

• Outside water supply systems will be built in the tourist regions in the mountains and along the coastline.

Transport sector

The investment to be secured through the consolidated state budget will amount to 19% of total funds planned for the period 1998 – 2001.

Main projects:

1. Development of air traffic in Bulgaria – funded through the consolidated state budget (own revenues) and through a loan with sovereign guarantees to be provided by EIB.

2. Construction of a new 2,5 km railroad, from railway station Gueshevo to the Bulgarian-Macedonian border and major reconstruction of railroad Radomir–Gyueshevo (88 km)– to be funded with the support of PHARE program.

3. Reconstruction and upgrading of railroad Plovdiv–Dimitrovgrad–Svilengrad–Kapitan Andreevo – to increase the speed to 160 km/h., which will redirect part of the road traffic and thus improve the natural environment conditions.

4. Reconstruction and upgrading of railroad Dupnitsa–Kulata (119 km.) from corridor 4 in the destination Bulgaria–Greece. The project covers: construction of electricity powering network and energy supply, reconstruction of separate sections of the railroad.

5. Construction of a new pier and new terminal in the port of Burgas – USD 113 m (facility of corridor № 8), to handle loose goods.

6. Expansion and reconstruction of oil port Burgas–Rosenets – funded from own revenues and foreign grants. Planned to be granted for concession.

7. Repair and development of Sofia airport (corridor 4 and corridor 8). The project includes:

a) passenger terminal with necessary equipment for 2,5 mill passengers per year; relevant platforms and regulation tracks; roads and parking places;

b) extension of existing runway;

c) cargo terminal for 30.000 tons per year.

8. Development and reconstruction of Burgas airport

The project will increase the handling capacity of the airport, improve passengers' service and safety of flights; improve service quality and decrease noise.

9. Combined transport terminal in Sofia. The objective of the project is to create a modern combined transport terminal in a juncture of strategic importance for the country – Sofia.

10. Container terminal in Rousse port (corridor № 7) located on the trans-European corridor № 8 and including upgrading and technological re-equipment of Rousse port.

11. Cereals terminal in Rousse port.

Energy Sector

1. Reconstruction and modernisation of unit 5 and 6 of NPS (Nuclear Power Station) Kozloduy.

2. TEPP (thermo-electric power plant) Maritsa-iztok 1. Two stages of construction.

3. TEPP Maritsa-iztok 2 – rehabilitation of units 1 to 4.

4. TEPP Maritsa-iztok 2 – purification installation for sulphur in block 8, funded through the program Energy 1.

5. TEPP Bobov Dol -construction of a transportation system, calibration and storing of coal.

6. Hydro power plant Tsankov Kamuk – the project is ready, technical designs and tender documents to be developed by NEC.

7. Water cascade Gorna Arda – a project in a region undergoing industrial restructuring, to be granted for concession.

8. Dam Yadenitsa of PHEPP (Pump Hydroelectric Power Plant) Chaira – completion of equipment.

FOREIGN INVESTMENT AS A RENOVATION FACTOR FOR BULGARIAN ECONOMY

Ilian Vassilev

Chairman, Foreign Investment Agency, Sofia

The ensuring of sufficient investments for economic restructuring, privatisation and capital market development is central to a successful reform. Investment in highly capital- and technology-intensive export-oriented sectors will be instrumental in rendering Bulgarian commodities and companies competitive as the country heads for integration with the EU, EFTA, CEFTA, the WTO and signs bilateral free-trade zone agreements. Greater demands are being placed on labour productivity, the capital base, management quality, corporate adaptivity and flexibility, management and diversification of entrepreneurial risk, administrative management, international mobility, market development, etc.

Within this context the levels of investment to a large degree shape the dynamics and character of economic growth.

EXPECTATIONS OF FOREIGN INVESTMENT TO BULGARIA

Global direct investment in 1999 is expected to exceed USD 440 bn of which Central and Eastern Europe may expect some 4.6 to 4.8% or some USD 20 bn. Over the years, Bulgaria's share in this amount has ranged between 0.75% and 3.25%.

In 1999, direct foreign investment in Bulgaria is expected to outstrip USD 1 bn. Privatisation proceeds, undertaken commitments and investment programs will boost Bulgaria's total investment resource and foster the servicing of its domestic and external debt. Privatisation generates a resource that is unique in time, one that can be employed as much for covering current deficits as for promoting longer-term growth.

Table 1
Foreign Direct Investment World-wide, in Central and Eastern Europe, and in Bulgaria by Years

Year	World-wide (WW)	Central and Eastern Europe (CEE)		Bulgaria		
	million USD	million USD	% of WW	million USD	% of WW	% of CEE
1992	175 841	4 439	2.52	34	0.019	0.77
1993	217 559	6 143	2.82	102	0.047	1.66
1994	242 999	5 914	2.43	211	0.087	3.57
1995	331 189	14 214	4.29	163	0.049	1.15
1996	337 550	12 344	3.66	256	0.076	2.07
1997	400 486	18 428	4.60	636	0.159	3.45
Total	1 705 624	61 482	3.60	1 402	0.082	2.28

Data source: World Investment Report, 1998 Foreign Investment Agency.

In this year, for the first time in many years, Bulgaria is expected to register a flow of foreign investments to its infrastructure in the form of feasibility studies, preliminary project- and logistical preparation of multiple large projects in its energy sector, telecommunications, transport and municipal infrastructure.

On the overall, both the structure and trends marking investment flows into Bulgaria are identical to those, characteristics of the region and global markets.

Table 2
Direct Investment into Bulgaria by Type and Year (in USD mn)

	Privatisation	Capital Market	Profits Reinvested	Other*	Total
1992				34.4	34.4
1993	22			80.4	102.4
1994	134			76.7	210.9
1995	26			136.6	162.6
1996	76.4		3.8	176.2	256.4
1997	421	29.7	5.5	179.6	636.2
1998*	168	54.8	16	239	477.9
Total	848	84.5	26	922.9	1880.8

*“Other” includes Greenfield investment and additional investment from abroad into companies with foreign equity.
Data source: The Foreign Investment Agency.

HOW FOREIGN INVESTMENT IMPACTS COMPETITION

How direct foreign investment (DFI) impacts the recipient country will largely depend on the latter’s macro-economic indices and even more so on the overall assessment, whether genuine or perceived, of their state and prospective development. Now that the process of investment and capital regeneration has assumed a global scale, there needs to be seen a due change in the national and corporate policy. Even in cases where export is not an essential condition for the sale of certain goods or services, foreign competition, if directly present on the latter’s home market will give a thrust to their international competitiveness.

A direct flow of funds is not the only expression of DFI; we can also identify it with the capital effect produced by the transfer of technologies, know-how and other intangible assets of international business, which are as important as hired labour and financial capital. How competitive and viable individual economies are will highly depend on the high-tech and science-intensive industries and services that foreign investments will bring in, and on the national economy’s ability to generate and add value, and absorb and maximise the DFI’s effect (example with the ISO standard and the SAP systems).

The impact DFI will have varies with its manner of employment: while direct investment in manufacturing boosts a country’s export potential and produces a maximum effect, the net effect is considerably weaker in the case where investments are made to build commercial and distribution networks, in as far as this generates little added value to the recipient country.

DFI has an immediate impact over competition in Bulgaria in several ways:

First, it is beneficial whenever it encourages local industries (i.e. improves the foreign balance of trade in technologies); thereby replacing imported products and technological processes. A technological advantage, whether own or obtained, has a more durable value and counts more than a dozen other competitive factors, such as cheap labour and inputs, to name but a few.

Second, the arrival of DFI acts as a catalyst for capital concentration and consolidation, being the only option for

Bulgarian companies to make a successful emergence on the international arena.

Third, DFI spills into raising the quality of corporate policy and more particularly its management and organisational aspects, ability to analyse and develop corporate advantages against the backdrop of a dynamically changing external market, etc. DFI has invariably the same 'spillover' effect: regardless of whether investment is in manufacture or under a delivery and distribution contract, it places higher demands on quality, regularity and timeliness of delivery, pricing policy flexibility, etc.

Fourth, the penetration of a market by external players often produces 'ripples in stagnant water', especially as regards monopolistic companies. This pushes companies, at first individual and then all sectors of the economy to speed up their restructuring in alignment with international criteria.

Fifth, the stringent enforcement of internal corporate management rules, control and reporting mechanisms helps draft clear rules of the game which fiercely clash with non-market forms of competition on the local market. The emergence of prominent external stakeholders is practically a chance to get the local market and social relations back to normal as they will, among other things, magnify the concealed defects of the socio-economic environment, such as contraband, corruption, crime, etc. Such an effect is envisioned to occur once the investment by METRO – a large multinational concern, which, made by big insuring companies and others, bears fruit.

Sixth, once the 'spirit is released from the bottle' and companies are ousted from their 'snug comfort' to be placed in a normal international medium, there will be price cuts (i.e. expenditures will shrink and goods and services purchased from monopolists will grow more competitive), and a need for local companies to adopt a corporate culture closely resembling that of large multinationals. Staunch domestic competition is the cheapest and most efficient way to teach Bulgarian companies in the art of competitiveness, all the more because Bulgarian business people encounter difficulties to travel, import technologies and export capital. As companies compete, they will restructure their technologies faster and enhance the efficiency of their production through traditional methods (depreciation allowances and tax preferences); faced with the permanent threat of losing markets or segments (real or imaginary) they will have the strongest impulse to act.

Rapid penetration of the local market by external competitors via goods not accompanied by their actual manufacturer may sharply raise competitive pressures. The premature or abrupt administering of orthodox market principles, which fails to take into account local specifics, can cause more harm than good. The only justification for such a policy would be if the 'imported' competition were deprived from support, as are its Bulgarian counterparts.

INVESTMENT POLICY AND INVESTMENT RESOURCES

1997 will go down in economic history as the first year in which the volume of international capital in circulation exceeded that of goods. Therefore investment will climb ever higher in every government's management and economic policy priorities (take South Korea for example).

To accomplish its structural and technological renovation Bulgarian economy needs to get hold of two types of investment- domestic and foreign. It is no secret that servicing the country's enormous external debt 'eats' into domestic investment resources to the tune of approx. USD 1 bn. Viewed against savings which are expected to have run at 14 % of GDP in 1998 and against government investment, this haemorrhage is critical. Any analysis of Bulgaria's medium and long-term credit and financial resources – and especially of the country's weak deposit base – makes it clear that foreign capital flows are the only viable option for financing Bulgarian long-term growth.

Increased lending to the private sector is predominantly due to worker-manager buyouts and not to credit for investment goods purchases. Unfortunately we have no information on the external private loans (borrowed from foreign companies), but s simple extrapolation of foreign investment volumes in Bulgaria of about USD 1,9 bn and the size of its domestic debt unequivocally show that lending as a source of DFI is prevalently external. This refutes the assumption that foreign companies are ousting their Bulgarian counterparts from the lending market.

A circumstance of particular concern is the fact that Bulgaria's foreign trade deficit has grown not so much as a result of the increased import of investment goods -the so-called 'useful deficit', as of private consumption goods import (food products inclusive), a market segment for which Bulgarian economy has the greatest potential. The current level of investment goods import does not condition a pronounced technological renewal of the economy or prospects for long-term growth.

Table 3
Structure of Imports by Basic Categories of Goods

	1995		1996		1997		1998[1]	
Category	**million USD**	**%**	**million USD**	**%**	**million USD**	**%**	**million**	**%**
Food, drinks and tobacco	455.6	8.1	402.7	7.9	428.4	8.8	520	11.2
Fuel and lubricants	1525.4	27.1	1711.3	33.7	1492.3	30.5	1008	21.7
Chemical products including Pharmaceuticals	802.3	14.2	637.1	12.6	593.3	12.1	715	15.4
textiles, leather, Confectionery and shoes	572.5	10.2	545.5	10.7	651.4	13.3	659	14.2
Investment goods[2]	706.9	12.6	567.7	11.2	562.7	11.5	613	13.2
Miscellaneous Goods	1575.5	27.8	1209.6	23.9	1157.7	23.8	1129	24.3
TOTAL	5638.2	100	5073.9	100	4885.8	100	4644.0	100

[1] The 1998 forecast is based on the correlation between the first nine months of 1997 and 1997 as a whole, as compared to the first nine months of 1998 plus structural data for the same period of 1998.

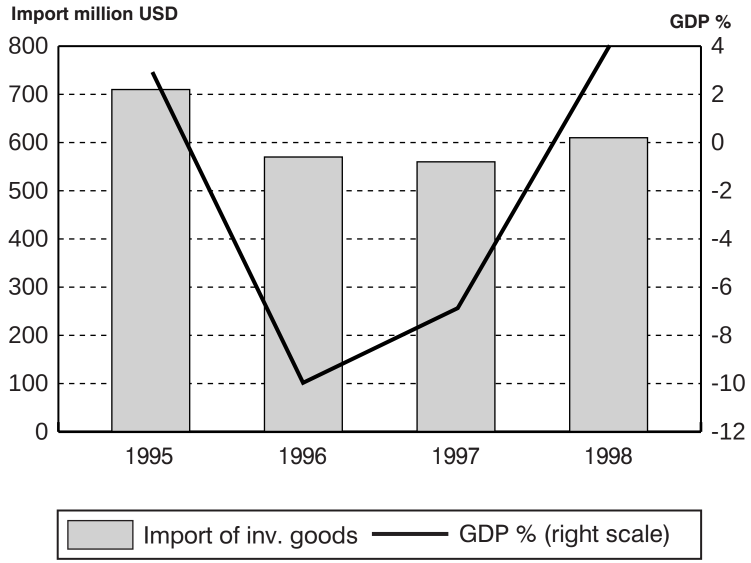
[2] 'Investment Goods' includes machinery, equipment and apparatus, electrical and electronics goods, after subtraction of domestic appliances.

Data source: NIS.

Additional light on the stake of DFI in this process is shed by the data, extrapolated for the machines and facilities imported under the Foreign Investments Act and repealed under the

Corporate Income Tax Act by the Customs General Directorate on the entire registered import of machines and facilities (under leasing contracts inclusive).

Figure 1
Investment Goods Import by Years (in USD mn) and GDP Real Growth (in %)



It is clear that *foreign investment plays a decisive role in the technological renovation of Bulgarian economy and is thus a key factor in shaping its prospects for competitiveness and growth. Considering the existing currency board restrictions, import of competition and technological crisis, the government's only rational economic policy now is to encourage companies to employ their own and borrowed funds in investment as much as possible, also through reducing the liabilities to the state in the form of taxes, duties and other "entry" costs.*

The most realistic opportunity of increasing corporate investment resources would be to effectively reduce business start-up and running costs. Financial stabilisation and more effective budget management would permit the launch of active investment incentives by means of cutting and relieving tax, duty and other 'hidden' costs linked with tax administration effectiveness and the investment environment as a whole. Bulgaria's growing foreign trade deficit only denotes that we are paying the taxes in other countries' budgets. The same holds true for duties.

THE ROLE OF INVESTMENT INCENTIVES AND PREFERENCES

The strongest incentive for multinational corporations to maintain a pro-investment mindset are the multiple forms of direct or indirect financial support on the regional, national and economic block level. Beside the all-valid factors of the investment environment, access to financial assistance programs, subsidies, low-interest or interest-free loans and other forms of financial commitments on behalf of the recipient country are central in shaping a decision to invest.

The CEE investment market cannot be ranked equal: internal financial resources are limited, dearer and less accessible. The economic policy is deficit-ridden since public and government administration propensity to 'think business' is not over pronounced.

Investment incentives and preferences based on strict and clear-cut criteria are features of improved and proactive government commitment that encourages and rewards corporate growth and industriousness, faster restructuring and higher economic efficiency, contributions to a positive balance of payments, etc. Regrettably, although a growing share of GDP is generated outside industry, the country's export structure is still dominated by traditional and primary process industries. Conversely, services – a sector where Bulgaria has a weak export standing – are taking up a growing part in the GDP.

Foreign investment and economic growth are the only realistic chance to solve problems like inadequate technology intensity and poor corporate management and business culture in this country. A recent OECD survey shows Bulgaria lagging way behind most economies as regards this indicator.

Investment volume and structure is an indicator of an economy's degree of integration into regional and global processes. As

such, investment directly contributes to mutual links of intercorporate and state nature. Moreover, while it is impossible to mark rapid advance in other factors influencing investment (such as corruption, "grey" economy, government administration, the inadequate quality of legal and physical infrastructure etc.), tax and investment incentives messages are readily communicable and bear fruit in a relatively short time.

Despite most international institutions' firm opposition to incentives and preferences which "erode" the rules of the market game, recent years prove that the offering of incentives and preferences is a mass and spreading phenomenon among all countries which have no substantial surplus of capital. Conversely, the assumption that the state ought to withdraw from its active involvement in regulating and stimulating economic processes has not found convincing support by any country, occupying a more backwards position among the emerging markets.

A consequence of regional and European integration processes is the appearance of a single investment market that makes it practically impossible conduct a purely national policy.

As whole Bulgaria has rather few unique and operational sales points *vis-a-vis* other CEE countries. One of its strongest competitive advantages – the labour cost/quality ratio in considerably capital-intensive sectors – is now 'out of order'. It is no secret that we are already experiencing a shortage of skilled labour especially in high tech industries. Migration abroad and away from the main profession of over 500 thous. citizens has practically rendered the problem a systematic one.

DIRECT FOREIGN INVESTMENT: A CONDITION FOR GROWTH

Economic stabilisation after March 1997 radically changed assessments of political and economic risk in Bulgaria. Along with the improvement of macroeconomics parameters, it is extremely important for economic benefits to be derived from political stabilisation.

Our limited human, physical and time resources clearly call for a selective approach and for the prioritisation of problems. A condition for attracting foreign investment is the drawing up of clear principles and priorities for individual sectors, provinces and nations to which investment policy will be directed. Being growth orientated involves stimulating the development and investment behaviour of the basic engines of growth: privatised and newly created businesses with or without foreign participation.

Success in ensuring a smooth transition between privatisation-led and infrastructure-led investment is of strategic importance in the policy of seeking foreign investment. The announced investment programme of the Government is good basis precisely for the elucidation of criteria and targets which should be set and attained by various authorities and institutions in various periods. Foreign investments have a strong spillover effect on government procurement. It is logical to assume that the state should attempt to leave as big as possible a portion of its costs in the country, thus generating domestic consumption.

It is clear that the state plays an important role in encouraging the infrastructure investment. The essential danger here lies in the state metamorphosing from being an honest broker and regulator into becoming a monopoly participant. There are many temptations since the dividing line between the two roles is thin: the lack of a culture, a tradition, and clear and open procedures favours the substitution of pseudo-state for business priorities.

The greatest possible openness in offering and carrying out infrastructure projects and government contracts is the most appropriate way to encourage competition and hence investment. To a large extent assessments of each nation as an investment environment emerge from the way macro projects are offered on the international market. In this sense, every project or procedure which is insufficiently transparent to the local or international public is also a missed opportunity for creating a desirable image. A number of companies' claim they would never bid for tenders, as if this were below their interest threshold. Their motive is more than obvious – to retain a set of privileged relations and contacts – for as long a period as possible.

In fact there is no company in the world that would miss out on business it is interested in. The opposite is also true: companies would not invest just because of the privilege of being selected to negotiate without a tender or a competition if there were no hidden benefits involved. If in time the international business community starts viewing the assignment of state contracts, the sale of state or municipal property, the awarding of concessions etc. as unfair or not transparent, that would form a negative impression among market participants too. This is not so much a matter of whether tendering or procedures are to international standards but of how they are perceived by participants and the media (so-called market and opinion makers).

In this respect, experience gained in carrying out large infrastructure projects can play an exceptionally useful role.

The attained and projected levels of domestic, foreign and outgoing investments to a large extent determine the dynamics and character of economic growth. They are also capable of considerably influencing this process by adopting changes in the macro- and micro-economic government policy of the recipient countries, adequate to the expectations of the investment process stakeholders.

Our chance to do this in the foreseeable future by the year 2001 is unique. We should not let it slip by.

COMMENT

Olivier Descamps

Director of Balkan and Caucasian States Department, European Bank for Reconstruction and Development, London

We have learned a lot today. I've learned a lot. I think it was very good to have the government invite domestic and international experts to give an educated advice. So I can only encourage such forums to help the transition from a state-led economy to a privately led economy.

If I had to wrap up what the three panel members talked about, in one way, is to say: foreign direct investment seems to be, no question, one of the only and major sources of support for the growth of a country. I could just give three suggestions.

On the privatization: the wind of opportunity exists but it may not last forever. There has been a very good progress in two or three things: prices have become more realistic, the privatization process is more transparent and accelerated. But you still have huge transaction costs, contingent liabilities, old debt, licensing, concession, legal risk. Without that, this privatization is not going to happen. The Privatization Agency's attitude to seek the investor versus waiting or negotiating from the position of a supposed strength is now much more realistic to go after. On the MBOs (management buy-outs), there is no doubt that the local private entrepreneur has the right, the talent hopefully, to run his own business. It's a way to transfer ownership. All these MBOs are going to fail in the near future except if you have a turn-around management for them, if they have new cash equity available, and if there is some strong corporate governance and institutional support.

The investment climate in Bulgaria. We can talk about giving a tax incentive, about promoting Bulgaria, but the investment climate is what at the end of the day everybody is going to look at. Is it going to be costly or difficult to do business in Bulgaria? Most of the advisors do agree on that- it's certainly a huge cost of investing currently in Bulgaria.

And infrastructure. The needs are enormous. And the one billion in concession or BOT is not enough. Probably the government has to accelerate the inflow of public utilities privatization. Once you have done the Telecom the other ones are going to be a bit easier. Energy is probably the biggest Achilles' heel in Bulgaria. Because it is, as people said this morning, an energy-intensive sectors. A lot of the foreign investors who are buying the big tickets, this year, or by the end of next year, are in an energy-related processing industry. We have to sort out the energy at the most cost-efficient way and have an energy plan, which is realistic for the new demand.

Finally, the financial sector- because that's part of the infrastructure for the small end medium enterprises. We will look at how many more private banks can do business, try to help them with more training. It's not just a question of lending money, but the collateral laws must be put in place.

The EBRD is going to, hopefully increase substantially its business and we would like very much, in the context of what has been done today, continue to also be part of this dialogue between experts to bridge the bottle- necks of growth.

COMMENT

Vassil Manov

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The subject matter of the conference entitled "Factors for Economic Growth in Bulgaria" implies that several questions should be answered, for instance: does the country need economic growth; what is the type of growth in the developed world and which are the major trends in the changes of economic growth at the end of the 20th century; are the factors for economic growth typical for the economy at large at the turn of this century present in Bulgaria; under what conditions can foreign savings be a factor for economic growth; what are the potentials of privatisation in its capacity of a growth factor; what is the relationship between stabilisation and growth?

1. Before we start to deliberate on the issue of how to make the transition from financial stabilisation to economic growth, it is necessary to prove the need for growth. There has been a suf-

ficient amount of negative experience from the past when campaigns used to be launched, our today's subject matter included. In order to exonerate the initiatives connected with economic growth from the suspicion of a yet another campaign and an exercise for its own sake, we should first prove and substantiate the objective need for attaining economic growth. And this need is not dictated by something external, it is determined by the logic of human development.[1] The success or failure of a reform is dependent and predetermined by the ability of this reform to imbibe in itself and obey the imperatives of human[2] development from lower to higher stages of civilisation. Experience shows that successful reforms can be observed where and when they secure not only procedural freedom for the citizens of a country but also when they first and foremost guarantee a genuine freedom – without hunger and the concerns for the day-to-day existence.

2. When the first question has been answered, the second one follows: "What is the type of growth in the developed world and what are the major trends in the changes taking place in it which bear upon the economy of the 21st century?" The economic growth of the first wave (as described by A. Tofler) has been of one type, it has been of another type in the economy of the second wave. Quite different is the type of growth in the economy of the third wave. When speaking about economic growth at the end of the 20th century, it would be a gross mistake to embody it in the notions about the economy of the second wave, and still worse – to think about the economy of the first wave. In other words, we need to clarify the link between economic growth and

[1] *C.f. Schlecht*, Otto, Foundations of and prospects for the socially-oriented economy, translation from the German language, published by Informa-Intellect, Sofia, 1997, p. 107: "In the conditions of an economic and social order, Otto Schlecht writes, based on the principles of freedom, the state should recognise economic growth as its major task; this economic growth should be established on the basis of society's interests and should stem from the functioning of the market mechanisms. Zero growth cannot be a goal of the government's economic policy because in this way the state would imprudently forego the individual desires of people."

[2] About economics as a science about man and the logic of man's development see *Marshall, A.*, Principles of Political Economy, Vol. I, translation from English into Russian, "Progress" Publishing House, Moscow, 1983, pp. 88–101, 145–166.

economic development, between economic growth and social development, between economic growth and environmental equilibrium. At the end of the 20th century, qualitative growth has replaced quantitative growth both in the sense of the positive result from growth and the productivity through which this result can be achieved.

3. Third, we have to answer the question: "Does Bulgaria possess the factors of growth available for the economy of the third wave?" What we need at large is an assessment of the endogenous potential of the Bulgarian economy for development, and the role of the Bulgarian economic environment which can either hamper or facilitate the country to make use of this potential. We need to assess the tendencies in the political, economic, social, natural, and technological environment of the Bulgarian economy, and what is of particular importance – to assess the impact of these tendencies on the Bulgarian economy[3] – both from the standpoint of creating additional favourable conditions for its development, and additional problems and hindrances for this development. We need to assess the potential of the Bulgarian economy for development, the possible rate of growth that can be achieved by this potential. In a different way and order the necessary rate of economic growth should also be examined and established. What is meant is the rate, which secures for the country the necessary conditions for a more rapid transition from a lower to higher degree of economic development and on the basis of this creates conditions for a systematic positive change in the living standard of the population. If the highest possible rate of economic growth, determined by the inherited structure of the economy, is lower than the necessary rate of economic growth, the country will inevitably need some kind of a "dope" (i.e. foreign, exogenous

[3] In a mutually interrelated world, or to be more precise – in a situation of growing mutual interrelatedness, in a situation of an increasing globalisation of a number of processes, this is of particular significance. It is especially important to become aware of the "butterfly effect" theorem. This theorem indicates – as Peter Drucker writes – "a butterfly fluttering its wings somewhere in the tropical forests of the Amazon, may influence the weather that will set upon in Chicago a few weeks or months later." (*Drucker, P.*, The New Realities, translation from English, Christo Botev Publishing House, Sofia, 1992, p. 167).

additional force). In this way the necessary state of certainty will be introduced concerning the amount of foreign financial funds the country needs.

It is insufficient to say that Bulgaria can cope with the difficult economic situation, that it can make the transition from stabilisation to growth if foreign investments are secured. We need to know the approximate size of foreign investments. And such a need also stems from the fact that the level of domestic savings is lower than the volume of investments we need for the more rapid economic development of the country.

4. The answer to the question about the amount of foreign investments the country need brings about another not less important question, namely: under what conditions it would be reasonable to resort to foreign savings and utilise them in the Bulgarian economy? Making use of foreign savings is equal to the conscious act of introducing disequilibrium in the economy. This is the reason why the answer to three additional questions becomes imperative, and these are: a) *how large* can this disequilibrium be; b) *how long* can this disequilibrium be maintained; (in other words the two questions are closely related to the circumstances under which certain disequilibrium can or cannot be maintained); c) *what model* of a financial programme is needed for the maintenance of such an disequilibrium? Because of the fact that foreign funds (savings) must be repaid in future, it is important that they be used both in a productive and effective way. Effectiveness bears upon *the question about the optimum and feasible levels of foreign loans as far as their sustainability is concerned, and the question about the optimum and feasible levels of the current account of the balance of payments, again from the view point of their sustainability.* The answer to these questions can and must be examined and regarded in a long-term time span. We must be aware that foreign savings do not automatically solve the issues of growth, and that notwithstanding the importance of securing foreign savings for the Bulgarian economy, it is twice as important to solve the issue of their productive utilisation, as foreign savings can be a particular boon. But at the same time they can become a factor enslaving the economy, should they be used in an inefficient and ineffective way. Effectiveness, which is an integral

characteristics of the quality of management in a given country, can of course be circumvented if the discrepancy between the level of domestic savings and the investments necessary for the accelerated transformation and development of the economy is made up for not by means of loans but through direct foreign investment. Circumvention in this particular case means that effectiveness becomes the concern of the foreign investor who has brought his investment into the country. But direct foreign investment is also far from being an absolute boon. And it is not somebody else but Milton Friedman himself who voiced a warning with respect to this.[4]

5. Almost always when economic growth has been discussed in Bulgaria, it has been inevitably linked to the privatisation process. Along the line of this factor of growth however, enthusiasm prevails over sober analysis as well. Dominant here is the notion that privatisation will automatically solve all problems of the economy. A delusive notion about the velocity and scale of the privatisation process also reigns supreme. It is considered that privatisation and decollectivisation can be identical to the scale and velocity of carrying out nationalisation and collectivisation in the recent past. In fact these are processes radically different in scale and rate of accomplishment. It was possible to nationalise property overnight by means of force; for about a year it was possible to accomplish the collectivisation of agriculture by force. As life has shown however, it is impossible for the process of privatisation to be completed within the same time span in which the process of nationalisation took place; it is impossible for the process of decollectivisation to be completed within the time frames in which the process of collectivi-

[4]See *Friedman, M.*, Privatise, Privatise, and Privatise Again, in: The Philosophies of Capitalism, translation from English, Pero Publishing House, 1996, p. 280 – “The next question, M. Friedman writes, refers to the frequent suggestions for enterprises to be sold to foreigners ... I think that this would be a mistake. First, the sale can be accomplished at very low prices, almost for free ... Second, in the long run and from the viewpoint of political considerations, it is not commendable for a large part of a given country’s means of production to be in the hands of foreigners. Do remember: foreigners will not invest in your country to help you, but to help themselves. Foreigners should be completely free to invest, given only however that this is in the interests of your country.”

sation was accomplished. This is not the result of a lack of willingness, this rather stems from the profound difference between these processes: they differ both in their essence and way of being carried out. Nationalisation and collectivisation forego individual interest; they were actually directed against it, in the name of the so-called societal interest. Nationalisation and collectivisation were processes analogous – irrespective of how strange it may sound – to a car accident. For a nick of a second the car may crash and can be deformed and twisted in the most incredible way; its engine, units and parts can be irreversibly damaged. For a nick of a second the bones of the passengers in the car can be crushed. It is impossible to restore the state of both the car and the passengers turned casualties from before the crash. This is how 50 years ago it was possible to accomplish nationalisation overnight, and 43 years ago to carry out mass collectivisation. Unfortunately, it is impossible to accomplish privatisation and decollectivisation within the same periods of time in which the reverse processes were completed in the past. In a word, when one relies on privatisation and decollectivisation as factors of economic growth, he should have a clear idea about the situation in this sphere. He needs to know the deformations that took place in people first and foremost: these distortions have resulted from the disturbed organic development of the economy and society, which took, place about 50 years ago.[5]

[5] C.f. *Brzezinski, Zb*., Out of Control (Global Turmoil on the Eve of the twenty-first Century), Obsidian Publishing House, Sofia, 1994, pp. 172-176. – Deliberating on the process of transformation in the Central and East European countries, Zbignev Brzezinski comes to the conclusion that the transformations taking place in these countries amount to the task of making fresh eggs from an omelette. “As a far-sighted observer – Brzezinski writes – has noted, there are recipes for making omelettes from eggs but there are no recipes to make eggs from an omelette.” “Poland – Brzezinski continues – was never made communist completely, neither economically (agriculture in this country, certain services and retail trade remained in private hands), nor ideologically ... This is why the difficulties of transition in the former Soviet Union are much greater, the stakes are much higher, and the scale cannot be foreseen ... The efforts Russia will make in the absence of definite concepts and models should lean on the specific heritage it has received from communism – not for the sake of its being made to last forever, but for the sake of people who should be able to free themselves from it in a way conducive for the establishment of a stable and democratic political system ... It is undeniable

One should seriously take into account the damage and deformation of people’s soul and body which communism inflicted on them.

6. It should be borne in mind that the currency board (in its capacity of an extreme economic policy) was called to the stage by an extreme economic situation – of a deep crisis and hyperinflation. The currency board as a policy for financial stabilisation was imposed by circumstances because growth was absent from the economy. Growth is necessary first to “rescue’ the currency board, and then to make it redundant. In order to make the transition to a normal economic situation and to normal economic policy, it is necessary for the current financial stabilisation to turn into economic growth.

that in Russia – unlike Poland – the entrepreneurial tradition has been almost completely eradicated, and private businesses have been destroyed. Communism left Russia the legacy of a society oblivious of the financial intricacies and the competitive mechanisms of the free market, as well as a state-governed economy on which the huge and inefficient industrial sector weighs as a burden. Given these circumstances, each attempt on the part of Russia to imitate the headlong rush of Poland to market economy could bring about a fatal discord between the political objective of democracy and the economic objective of the free market ... It will take years for the former Soviet Union to be able to establish the necessary entrepreneurial ethic and to privatise the existing economic system, years – in fact whole decades – of continuous and patient endeavours. Hastiness will cause not only serious losses, but would probably throw Russia into a revolutionary situation. This probability may even increase, especially if mass unemployment occurs, brought about by an erratic policy of hectic privatisation and/or the bankruptcy of the major Russian industrial enterprises. The naked reality indicates that even in the best of circumstances large sectors of Russian industry cannot be privatised because they lack competitiveness, and their closure will generate unemployment to the order of tens of millions. The situation in agriculture is just as grave. In the conditions of a ruined peasant population and given the presence of numerous kolkhoz/sovkhoz possessing machinery for large-scale farming only, it is unlikely for decollectivisation to attract many would-be private farmers; from an economic point of view it can even suffer a failure. Thus things can turn into historical irony if the collapse of communist dogmas makes Russia’s postcommunist leaders stick to the new dogma of the free market in a simplified way, regardless of the social price and the political risks. Yet, such precisely is the advice flowing from the West to Russia. Russia is constantly made to build democracy and create a free market at one and the same time. This advice is being turned into a dogma by an elite who have too dim and remote an idea about the sensitive link between culture and economy and who chant “free market” incantations with the same ritualistic formalism with which their predecessors proclaimed their loyalty to the construction of socialism.

EXPORT ORIENTATION AND ECONOMIC GROWTH

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Foreign Trade Volume, Dynamics and Structure, Prices and Conditions of Trade

The openness of Bulgarian economy makes it easy to see that foreign trade fosters economic growth. While import ensures a supply of raw materials to the economy, it is through export that a part of the finished goods are shipped abroad. The increasing importance of foreign trade in boosting economic growth is evidenced by the trend in the correlation between the foreign trade indicators and the GDP, where the degree of dependence is greater in the cost volumes, a circumstance indicative of the impact prices exercise on economic development.

Once we have identified external demand as a lever to economic growth, the next logical step is to examine the opportunities for expanding the export and the related import, and the factors that intensify external demand. The most important among them are: the treaties, entitling Bulgaria to associated membership in the EU and full membership in CEFTA, the free trade zone agreements and those serving to promote diverse forms of economic co-operation (avoidance of double taxation, foreign investments protection, etc.), the overall decrease of duties (resulting from the operation of the above-mentioned treaties and agreements and the implementation of the WTO conventions), the dynamics of demand on the external market, non-price factors having to do with the quality, consumer properties, design, etc., of commodities, the export infrastructure (the existence of factors, such as viable, export-promoting entities, an export-crediting system, an agency for insuring and securing export credits, etc.).

The state of Bulgarian foreign trade and its prospective development as a factor for economic growth are best disclosed by looking at its volume, dynamics and structure. In 1992-1997

trade grew by 16.8%, that is, from USD 8.4 bn to USD 9.8 bn. Export increased by 25.3% and totalled USD 4.9 bn. Import in 1997 also reached about USD 4.9 bn, registering a 9.3% increase since the beginning of the period. Unlike previous years, 1997 witnessed a positive balance of trade (by prices for the corresponding year), amounting to USD 28.1 mn. Despite its overall upward trend throughout the examined period, Bulgarian trade gradually declined after 1995, as did the trade of countries in any other region or group.

The geographic structure of Bulgarian export confirms its primarily European orientation: in 1997 Bulgaria's export to Western Europe added up to 35.9% against 32.3% in 1995 and 28% in 1992, or an average of 32.1% for the given period. Throughout the studied period Bulgarian export was nearly equally divided among three destinations: Central and Eastern Europe, Western Europe and countries outside the European region. By mid-1998 nearly 47% of Bulgarian foreign trade (50% in the export and 44% in the import) was conducted with the EU.

The most vivid changes in Bulgaria's import during the studied period – an increase of 40.9% – are associated with its partners from Central and Eastern Europe. Import from the CIS increased to 56.3%, from Russia – 38.8%, from CEFTA – 5.2%. Import from the EU grew to 31.3% for the same period. Post-1995 imports dropped by some 14% both as a whole and by geographic destinations. A marginal growth of 5.2% was registered in the import from the CEFTA countries only.

Throughout the studied period Russia, Germany, Italy, Turkey, Greece and the Ukraine retained their lead among Bulgaria's trading partners, being accountable for nearly 50% of its trade. Russia and Germany – traditional partners to Bulgaria – claimed more than 40% of its import; its export, 40% of which were divided among the five above-mentioned countries, had a less concentrated structure. This speaks of tight links between Bulgaria and its traditional trading partners.

The analysis of the commodity structure between 1992–1997 reveals that the first six positions are occupied by invariably the same commodity groups, whose share has continuously grown from 66 % in 1992 to 80% in 1997. This change is conditioned mainly by the pick up of trade in metallurgy products, textile materials and chemical products. Throughout the period mineral products held the unchallenged lead with a share of 22%. Meanwhile the share of agricultural products in the commodity structure of trade declined.

The largest increase in 1997 was registered by the cost volumes of the light industry exports (textile materials and articles thereof, shoes) and of mineral products – by 77.9%, 57.6% and 46% respectively, as compared to 1992. Having lasted from 1992 to 1996, the trend of growth of the chemical industry export vanished in 1997. After a certain, albeit an inconsistent growth in the export of plant products, food products, drinks and tobacco, plastics, natural rubber and articles thereof, and timber until 1995, there has been a durable drop in all of these groups over the past two years, leading to a shrinkage by half of the plant products-, and by nearly 10% of the food products export.

Over the whole period metals (ferrous and non-ferrous), and their products held the lead, with a share of approximately 20%. With certain reshuffling over individual years, next in rank were chemical products, food products, drinks and tobacco, textile materials and articles thereof, mineral products and others. Export of livestock and derivative products lagged considerably behind in this ranking – their relative share in 1997 declined three-fold as compared to 1992. The first six commodity groups in the export structure form more than 75% of Bulgaria's overall export for 1997, exceeding their 1992 share by more than 6 points.

Until 1996 there was a continuous upward trend in the dynamics of the export/import and in most commodity groups, but it subsequently died down. After that year, only in the import of textile materials and articles thereof, and of leather and leather goods, has the continuous growth of the overall cost been preserved. A stable trend of decline has become typical for the import of transport facilities, food products, drinks, tobacco, fats and oils after 1993.

Mineral products, machinery and electrical equipment occupy the top two places. Mineral products import (crude oil, natural gas, petrol products) takes up 1/3 of the total import over the

past two years, speaking of a high degree of concentration. In 1997 the first five structure-determining groups of commodities accounted for a little more than 70% of Bulgaria's total import – as much as in 1992. The insignificant variation over individual years was largely dependent on the changes in the share of the most dynamic groups, namely textile materials and articles thereof, and mineral products.

Over the better part of the studied period, Bulgaria had a negative foreign trade balance. Only in 1997 did it form a positive balance of trade in the amount of USD 28.1 mn. A commodity break-down of the balance would show that prevalent in the import from countries with which Bulgaria maintains a negative balance were mineral ores, machinery, appliances, transport means and pharmaceutical articles; in the export for countries with which Bulgaria maintains a positive balance there prevailed light industry products, machinery, appliances, mineral products, pharmaceutical articles, food products. On a regional scale the greatest negative balance was registered with Bulgaria's largest trading partners, Russia and Germany; the greatest positive balance was registered in Bulgaria's trade with other Balkan countries (Turkey, Yugoslavia, Greece and Macedonia), and with some CIS-countries in 1997.

The contrastive analysis of Bulgaria's export prices reveals that Central and Eastern European countries and the CIS offer the highest prices, a statistic based on the prices established for the export of ferrous and non-ferrous metals, chemical products and plant products for the CIS, which are twice as high as for the remaining countries despite the well-pronounced trend of decline. Next in line are the EU member-states, where the trading prices are higher than those average for Bulgaria's domestic market. The lower price level for the export as a whole is the result of the considerably lower prices at which similar output is sold in other parts of the world. A pronounced downward trend in the dynamics of export prices is characteristic of the Arabic countries, while an upward trend marks the dynamics of export prices to the Balkan countries.

To assess the competitiveness of Bulgarian exports based on the prices negotiated on the external markets, we can apply the conditions of trade indicator, disclosing the ratio of changes in the export and import prices. Estimates show that between 1992-1997 the conditions, measured by the ceiling index have improved as a whole (106.3), yet there are great disparities by individual commodity chapters from the customs tariff. Most commodity items (over 100) are sold at better- and 30% at worse trading conditions; at the same time they constitute nearly 50% of Bulgaria's entire export.

The fact that 80% of Bulgarian export is concentrated in six sections of the customs tariff (out of 21 in all), in half of which there can be seen unfavourable conditions of trade, allows us to draw conclusions regarding the efficiency of Bulgarian export. Ferrous, non-ferrous metals and chemical products for instance, took up 37.5% of Bulgarian export in 1995, yet the conditions of trade index applied to them was 72.1 and 66.1, respectively. Machinery took up a little over 9% of the overall export and although the conditions of trade index was favourable (an average of 120.1 for the period), its dynamics was inconsistent and in individual years it dropped below the 100 points level. Textile materials and articles were the only commodities where a notable and stable improvement was registered in the conditions of trade, paralleled by a swift growth of volumes. Good conditions of trade were also achieved in the trade with livestock, fats and oils, mineral products, shoes, construction materials, but their share in trade was not especially high. Many food products were sold in favourable trading conditions, yet these are normally items with a small share in the bulk of exports. At the same time the export of staple export goods, such as tobacco and drinks, was accomplished in deteriorated trading conditions. The same applied to chemical products, which have a large relative share and worsened conditions of trade.

A more exhaustive picture of the conditions of trade can be obtained by scrutinising the conditions of the individual export markets for the relevant Bulgarian products. A comparative study reveals that the best conditions of trade were initially offered by the Central and Eastern European countries and then by the Balkan countries as of 1997. 1995 was the starting point for an upward trend of the indicator for the Balkan and Arabic countries. Sizeable improvement in the conditions of trade was achieved with the EU member-states: by the middle of the studied period this market offered trading conditions above the average for Bulgaria's domestic market.

Thus, the study highlights several sectors of the Bulgarian industry as export-oriented and well-positioned on the external market, namely, the textile industry, shipbuilding, the shoe industry, the agrarian industry (agriculture, the food industry, the tobacco industry, wine-making), the chemical industry (manufacturing of fertilisers, essential oils, organic chemical products), and metallurgy (ferrous and non-ferrous).

The change in conditions on the international markets in 1998, accountable for the deterioration of the conditions of trade and competitiveness of some of the above-mentioned commodity items does not imply that they should be removed from Bulgaria's export list. The new situation proves a long-drawn conclusion – that most of Bulgaria's export-oriented manufacture is in need of a long-term restructuring policy, ensuring its improved efficiency and better external conditions of trade.

The Role of Bulgaria's Foreign Trade Policy in Ensuring Economic Growth

In order for foreign trade to foster economic growth more effectively, there needs to be conducted an appropriate foreign trade policy involving the liberalisation of trade and Bulgaria's speedy integration to the European and global markets. This is the underlying rationale in the actions of the Bulgarian government in its efforts to meet its international commitments in relation to Bulgaria's membership in the WTO, the trade agreement for association with the EU, the agreement with EAST, the accession agreement with CEFTA, its bilateral agreements for free trade and others. And although the latest modifications of the foreign trade regime as of early 1999 could claim that it has been liberalised to a considerable extent and meets free trade requirements, there is still a lot to be done with respect to Bulgaria's regional foreign trade policy. The course of this policy which we believe is congruent with the interests of Bulgaria for full-fledged participation in the international distribution of labour, integration with the European economic structures and achievement of an economic growth, could be outlined on the basis of the general features of the trends in the development of Bulgarian foreign trade.

The changes in the geographic allocation of Bulgarian foreign trade, which intensified trade with the EU member-states and notably improved the trading conditions, could be explained by the relatively low size of trade up until the end of the 80-ies, the improved trading climate achieved by the signing of the European agreement, as well as the shrinkage in domestic demand and the national currency devaluation, rendering export operations profitable. As a whole, commercial liberalisation and the greater access to the EU market enabled Bulgaria to boost its exports, yet the opportunities for this practice were soon depleted and the positive trend was eventually reversed. Although nearly 40% of Bulgaria's competitive exports are still directed to the EU and succeed in retaining their market niche, the requirements towards their quality, manufacturing and compliance with the EU standards will increase, thus rendering their supply more and more difficult. In the future, the only talks possible will be for expanding the EU market access to Bulgarian farming products, wines, fish and fish products.

Since the collapse of Bulgaria's trading and economic relationships with the Central and Eastern European countries (CEFTA, Russia, CIS, the Baltic States, the former Yugoslav republics), its trade with them, although accountable for 35-40% of the total volume of trade, is developing irregularly. The conditions of trade index remains above the average for the country, yet it follows a trend of continuous deterioration. Moreover, there are significant differences among the countries in the above-described region.

In recent years the CEFTA countries have been losing ground in the Bulgarian foreign trade, although it is on this very market that Bulgaria achieves the best trading conditions in its export of agricultural, food and chemical products, machines and transport facilities. The similar difficulties afflicting transition economies in their efforts to adapt to free market competition, are forcing them, while liberalising their trade, to resort to identical measures of protection towards the import of sensitive commodities (agricultural products, metallurgical products, textile, ready-made garments, paper manufacturing). These are commodities,

traditionally manufactured by all of the above countries, and the all too quick liberalisation of trade would have an adverse impact on their manufacture and domestic markets.

As the agreement on Bulgaria's accession to CEFTA becomes effective on January 1st, 1999, mutual trade will receive a certain impetus, yet no sizeable increase in volumes should be expected. The lowering or lifting of duties on the import of certain Bulgarian industrial products will improve their access to the CEFTA market but while eliminating the discrimination towards them it will not automatically produce a greater demand for them. The greatest opportunities for boosting supplies are related to pharmaceutical commodities, machine-building products and spare parts.

The factors, influencing the dynamics and conditions of trade with Russia, are: an unbalanced volume of mutual trade, leading to sizeable negative balances for Bulgaria; instability of the Russian market, application of a series of protectionist measures and additional requirements, provision of a preferential customs regime to potential rivals of Bulgaria on the Russian market; a lack of special agreements as are those, aimed at establishing free trade zones with the Central and Eastern European countries. All the above, coupled with the severe crisis rocking Russia, has led to a significant decrease of trade in 1998; however, the talks incepted on a broad range of commercial issues, the multiple solutions offered and the understanding shown by both sides about the gravity of the problem give grounds for hope that a positive outcome will result.

In a situation like this, any plans and agreements for liberalisation of trade would be beneficial. There comes to the fore the need to draft new strategies and priorities. To ensure a durable presence of Bulgarian companies and commodities on the Russian market, there needs to be made a selection of such market penetration and expansion strategies, as would permit a more active involvement of the small and medium businesses in the export and import, and elimination of a part of the commercial mediators that encumber trading relationships and render them riskier. It is especially important for Bulgarian manufacturers to establish a direct contact with their Russian counterparts or consumers.

The successful progress of Bulgaria's trade and economic co-operation with the Balkan states (which have a more than 18% share in its trade, marked by sizeable positive balances in what are some of the best trading conditions), is shaped by diverse factors at play: common boundaries, largely similar socio-economic problems at hand, a geographic location which presents favourable opportunities for implementing large-scale infrastructure projects, etc. Everything mentioned so far gives us reasons to think that Bulgaria's active foreign trade policy aimed at the creation of free trade zones on a bilateral basis with view to elimination of all non-tariff obstacles and boosting of trade, is a move in the right direction. The positive impact of the now effective agreement with Turkey will perhaps be felt not only as a notable growth in trade, but also as a livelier investor interest towards Bulgaria. Negotiations for setting up free trade zones with other Balkan states are still at the expert study phase, awaiting further significant progress.

The ascending trend in the dynamics of the conditions of trade indicator in the trade with Arabic countries speaks of their significance to Bulgarian foreign trade. Until the late 80-ies these were key trading and economic partners to Bulgaria, to whom a sizeable bulk of commodities was exported. They were also a major field for engineering operations, accomplished by Bulgarian companies. Although in recent years the volume of trade with this region has been on the wane, a positive balance of trade has been maintained. In this sense the development of trade with these countries holds a potential for economic growth.

The key aspects of Bulgaria's foreign trade policy chiefly address the issues of rendering Bulgarian export competitive and opening new possibilities for its expansion on the international markets. Moreover, one of the major conditions in the way to Bulgaria's full-fledged EU membership is its capacity to deal with the competitive pressure of market prices. It is a fact that the dynamics of Bulgarian export over the last 5-6 years has been predominantly shaped by the changes on the international arena, rather than by its enhanced competitiveness. Yet, in the long-term these factors cannot be counted on for increasing the competitiveness of Bulgarian export and improving the conditions of trade. That is why a major objective of the government's policy should be the increased competitiveness of Bulgarian export products by making use of the specific comparative advantages of the country.

Currently, nearly 55% of Bulgaria's total export consists of mineral ores, half-finished materials and farming products. This export structure, based on the manufacturing industries and those, involving the manufacturing of half-finished materials (ferrous and non-ferrous metallurgy, heavy chemistry and cement industry), could not be the source of a stable economic growth in the longer-term, since it does not match the structure of Bulgarian economy. While certain types of export manufacturing relied for a long time on preferential pricing, the current international market conditions call for enhancing competitiveness through product diversification and innovation, technological advancement, optimisation of the input of energy and materials in the manufactured products, higher labour productivity, etc. We are hereby talking about the manufacture of products with quality raw materials which has established traditions and boasts a trained workforce, a competent engineering and technical staff, and a track record of own research results it actively employs. These products are chiefly marketed to countries with a developed market economy and consist of textile products and ready-made clothes, shoes, diverse food products and cans, certain construction materials, timber products, electrical equipment, etc. Other types of products that fall into this category are the ones whose manufacture is highly dependent on imported inputs or is highly energy-consuming (such as the chemical or pharmaceutical industry), but still possess a significant potential for competitive advantages. Despite the worsened global market conditions, industries that export 80% of their production are in need of an export policy, based on a realistic assessment of the absorptive capacity of the external markets.

Industries that are dependent on agricultural raw materials are working well below their capacity, although they present unquestionable competitive advantages to Bulgaria. The lack of a concrete, motivated policy for agriculture deprives the food industry (dairy, canning, winemaking) and to a large extent the light industry (textile and shoe industry), from high-quality raw materials. As a result of this Bulgaria has lost access to the

European dairy market and to the Russian can market, and has increased its demand for the import of textile raw materials, locally produced until recent years.

There also exist industries with a potential competitiveness, which could exert a greater influence over the economic development of the country in the long-term. These are the high-tech export-oriented industries with a large export volume in the past that has strongly declined since the early 90-ies due to economic policy changes or to some insurmountable unfavourable external circumstances. Given a sufficient inflow of direct foreign investments, these industries could quickly regain their competitiveness. These are chiefly high-tech industries developed as a priority on the basis of the export specialisation assigned to the former COMECOM member-states (non-standard equipment, military industry, and electronics). In the past, they absorbed sizeable physical and human resources and had the relevant economic and scientific infrastructure created in their support. To restore their capacity would not be that difficult a task.

In conclusion, economic development could be boosted by an increased external demand of commodities with a high degree of finishing. This calls for utilisation of the competitive advantages of the economy in the broad sense, and the conducting of an appropriate policy by sectors of the industry. This potential solution is best suited to the restrictive conditions of the currency board, where relatively small-scale resources could be applied in the development of industries to serve as locomotive engines for economic growth at present.

COMMENT

Andrew Warner

Harvard Institute for International Development

First of all I would like to thank Mariela Nenova and George Prohasky for organising such a diverse and successful conference and inviting all of us.

In commenting on this paper, let me first mention the basic point that the paper is right to emphasise exports as an important ingredient in Bulgarian growth, and in identifying many of the factors that are important for the export sector. The basic fact about exporting in Bulgaria that is worth stressing however, is that despite having one of the highest levels of education in the world, and extremely low wages, our latest data still shows that export growth was negative in Bulgaria in 1998. This is extremely surprising in an economy with such a high level of education relative to wages and with Bulgaria's huge success in macroeconomic stability in the past two years.

In order to achieve rapid export growth and rapid growth overall, Bulgaria must change what it produces. Bulgaria's industrial structure was designed in Moscow in the 1950s and the 1960s, not in Sofia. To a large extent, your industrial structure is still too close to the one designed in Moscow. Surely the record of the first half of the 1990s shows that this industrial structure designed in Moscow will not lead to rapid growth. This is as true for exports as it is true for the rest of the economy. Most economies that have rapid growth show dramatic changes in industrial structure along the way.

The important point is that to change your industrial structure you must allow new businesses to form and new industries to develop. In this regard let me mention a survey of 50 leaders of Bulgarian firms that were interviewed in a survey that we conducted along with the Center for Economic Development. We asked whether it was easy or difficult to start a business in Bulgaria. We also asked the same question in 59 other countries around the world. Out of 59 countries Bulgaria was dead last: number 59 out of 59. Apparently people here feel that it is extremely hard to start a business. How will the new exporting sectors emerge in such an environment?

It is helpful to think about the discussion on industrial policy in this context. The paper I am commenting on recommends that Bulgaria concentrate on Textiles, Shipbuilding, Shoes, Chemical industry, Metallurgy, and Agriculture. Earlier today Professor Sachs recommended Light Industry, Agriculture and Food processing, Electronic and information processing, and Tourism. Let me suggest some of the advantages and dangers in this kind of industrial policy.

First, the reason Professor Sachs recommends policies to actively encourage foreign direct investment in these sectors is because it is hard today to find an example of a fast-growing country that has not pursued some kind of active policy to encourage foreign direct investment. Ireland is one of the fastest growing countries in Europe and offers sharp tax reductions to foreign investors. This is true for many of the other fast-growing countries. This does not prove that you need foreign direct investment promotion for fast growth, but it is strong evidence that should not be ignored.

There is always a bias towards the status quo in economic structure. Structural change means that people have to work in new jobs, new businesses have to form, and all of this is costly, so naturally there is some resistance. The problem with industrial policy is that it may actually reinforce this natural bias towards the status quo. The first reason in intellectual. The evidence to back up the arguments about what industries to develop tends to come from what industries exist. By definition, industries that do not yet exist in Bulgaria have not generated supporting evidence. The second reason is political. Industries that do not yet exist do not have a lobby to support them. The industries that exist now can pressure the government for support, and this will reinforce what you already have.

So for all of these reasons the danger is that the industrial policy debate will exacerbate the status quo bias and make it more difficult for Bulgaria to grow by moving away from your industrial structure designed in Moscow.

Thank you.

COMMENT

Thomas O'Brien

Resident Representative for Bulgaria, World Bank

Both of the papers presented by respected colleagues from the Agency and the Ministry of Trade are indeed very welcome papers. They are grounded in a detailed empirical assessment and analysis of Bulgaria's trading position since the start of the transition. The research includes quantitative analysis ranging from the broad aggregate of export and import data as a share of GDP, right down to an analysis of flows of exports and imports at the detailed level of 97 products in the Harmonised Classification System. The authors should be congratulated for the effort and attention devoted to this review. I would also recommend making this available in computerised form to stimulate and support follow-up research by other interested economists.

Exports as an Engine of Growth. There is no doubt that exports can serve as one of the engines of economic growth for Bulgaria, and in this regard it is clearly an important issue for researchers to examine and for policy to address.

One should note that over the last decade, there have been countries – primarily in Asia – where rapidly growing exports have helped strengthen GDP expansion and improve living standards. This is revealed in the table below, drawn from World Bank data: but it also shows that the countries in the Europe and Central Asia (ECA) region – that is essentially the countries of Central and Eastern Europe and the Former Soviet Union – have as a group experience rather poor export performance over the last decade. This indicates that Bulgaria, like others, has a way to climb before its export performance has a chance to be as strong and as big a contributor to economic performance, which we would all like it to be.

Export Volumes: Average Annual Growth: 1987 – 1996

Region	Export Growth, % p.a.
ECA	1.3
The World	6.3
East Asia	14.0

The World Bank's latest global economic forecast is a little rosier in terms of the export outlook for the ECA region, as indicated in the table below:

Global Economic Prospects (October 1998) –
Export Growth, % p.a.

ECA	1997	1998	1998–2007
Export Growth, % p. a.	7.9	3.8	5.7

Nonetheless, if Bulgaria can match this expectation it will have done well, since we know from the latest figures that exports are currently being compressed quite sharply. Indeed traditional industries – chemicals and heavy metals – are being squeezed sharply through 1998, and in the first three-quarters of the year, there is reported trade deficit of USD100m. All this simply to recognise that to improve exports is not a short-term shot-in-the arm for economic growth: rather it is a long term, strategic plank of economic development.

Exports, and export growth performance are dependent, probably in the short/medium term, and certainly in the long run, on a sound domestic economic environment. Key ingredients of establishing this sound environment include:

- Macroeconomic stability – and here there is a direct and forceful link with the CBA and its continuance for the foreseeable future;
- Market friendly policy for business, including a regime which can help attract FDI here the Bank is helping in what we term Finance and Enterprise Sector Adjustment Loans (FESALs), which focus on privatisation and other marker reforms which the Government is pushing forward on

- Institutional capacity and effectiveness. Here the Bank is seeking to help, with other donors, on public administrative reform.

One of the implications of the CBA (which by the way, certainly helped Bulgaria withstand recent pressures associated with the Russian financial crisis) is that there is no scope for devaluation as a way to improve competitiveness and hence boost exports. This is no bad thing, as such a policy is short-term in nature and typically fails to achieve its goals. Rather a country needs microeconomic reforms, which help produce productivity gains and control of unit costs.

Let me say a few brief words about a selection of policy issues, of policy focus, which are important to export potential and economic growth prospects as a whole.

A. Continuing focus on to EU

Here there are many challenges, but one particularly relevant to export performance includes meeting EU standards e. g. veterinary and phyto-sanitary standards in agriculture and food processing; and sharpening the competitive edge of domestic business. Already Bulgaria has about 50 percent of its trade with the EU (compared to an average of 53 percent for the 10 applicant countries as a group).

B. Sector reform – agriculture; tourism; energy

As an example, the World Bank is helping with a proposed Agriculture Sector Adjustment Loan (ASAL), and investments, in land cadastre; Irrigation; with other donors supporting grain warehousing; port infrastructure.

C. Completing the well-advanced progress of trade reform

D. Improving connectivity

This is what one speaker referred to as "networking".

The Bank already has investment in railways and telecoms, and is looking at ways to improve cross-border trade facilitation in the context of the SECI initiative. Other donors are focusing on roads, airports, and seaports, in a complementary way.

E. Industrial Strategy

Here there is scope for market-friendly support – not heavy-handed direct Government intervention – which can help encourage growth of high-value exports in sectors that are at present competitive or are potentially competitive. Sectors worthy of close investigation include, but are not limited to, high-technology hardware and software; light manufacturing; textiles' agriculture; and tourism.

Conclusion

Finally let me just emphasise that we have spoken today on key factors for economic growth – and focused, understandably, on the economic dimension – laws, policies etc. But we at the World Bank also want to stress the other dimensions;

- social,
- cultural,
- human.

It is equally important that we all pay great attention to these dimensions, if Bulgaria's ambitious and praiseworthy efforts to modernise its economy and society are to bear fruit in better, sustainable, standards of living for all its people, from the advantaged to the poorest in society.

TAX POLICY AND ECONOMIC GROWTH

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The following conclusions have been formulated and substantiated on the problems explored:

1.The financial stability, secured by the monetary system of the currency board is a general precondition for promoting investment activity and economic growth. Among the other prerequisites are achieving political stability, fast and transparent privatisation, liberalising the markets, reforming the social sphere, curbing of bureaucracy, crime and corruption. Should the wishes to eliminate or to "mitigate" the currency board in order to stimulate economic growth, including through inflationary financing, be fulfilled, the effect would be just the opposite.

2. The continuing stagnation following the hyper-inflation and crisis of the end of 1996 and the beginning of 1997 could be explained besides with the delay in the privatisation (30% by the end of 1998 instead of projected 50%), but with sharply decreased domestic demand. The real salaries and pensions by the end of 1997 have dropped by 58% and 69% respectively as compared to 1998, that is twice the fall in the GDP in the same period – 30 %. The shadowy business groupings and criminal structures, that have embezzled the balance, are not willing to invest the "dirty money" in the Bulgarian economy. The access of small and medium private businesses to the financial markets is impeded. The debt of the state-owned companies that has reached 12 000 trillion BGL in 1999 has almost paralysed their activity.

3. Under the Currency board it is impossible to use traditional monetary tools like the base interest rate for example, in order to exercise influence on the economic cycle. Given the present conditions, a more substantial decrease of tax rates accompanied

by a decrease of their differentiation and tax relieves, could give a definite impetus to enhancement of investments both from internal and external sources and to accelerating the economic growth.

– If the ceilings of the personal income tax rates and of consumption taxes equivalent to them are lowered, the effect on income would be positive rather than negative, and a definitely positive effect of substitution would occur, connected with the supply of labour, than typically occurs in a normal economy. Since even if tax rates are reduced by 20 and more percent, the net income of the majority of the population will not reach the social minimum nor even the existence minimum of poverty. The value of leisure time continues to be too low as compared to the prices of consumer goods, that is why these two factors will stimulate a greater supply of labour. The distortions and dead weight of losses from tax evasions will decrease dramatically as a result of reductions in labour employed in the shadow businesses and in-kind economy and the associated with them payment of salaries in a non-monetary form or their concealment.

– The curve of indifference will run at a higher level of labour supply, as the tax rates decrease significantly and this will cause a relatively slower increase of the salaries compared to the increase of the productivity of labour. This will have a positive effect, i.e. lower prices of goods and enhancement of their competitiveness on the domestic and international markets.

– The reduction of the tax rates' ceilings and elimination of their differentiation will reduce the sources and incentives for corruption in the tax authorities. This, alongside with the introduction of a unified information system, will lead to a significant increase in the collection of taxes and customs duties

– Should the maximum rates of the basic taxes decrease to 30–32 % in the conditions of a financial and political stability, Bulgaria will gain significant advantages in attracting foreign investors to participate in the privatisation and technological and structural renovation of the production. The internal accumulation of enterprises will increase, together with their capacity to use and promptly repay bank loans.

– The massive inflow of foreign investments, the higher rate of internal accumulation and increased real income of the population will ensure significant and long-lasting expansion of the domestic demand, which at least partially will offset the narrowing of the external markets due to the crisis.

The impetus resulting from lower tax rates stepped up privatisation and expanded investment and domestic demand could lead to an increase of the GDP by 8–12 % per year. And this would not be an economic miracle given the extremely low starting point and the potential of the country.

4. The amendments in the tax laws made in the end of 1998 reduced the maximum rates of the principal taxes by less than 10%. The main reason for the Government and the IMF to reject the proposals for a more significant decrease was the risk of impairing the achieved financial stability. The analysis indicates that in practice such a hazard does not exist. That is because the losses of the budget from the decrease in the tax rates are totally offset by the increased volume of budget revenues as a result of stimulated economic activity, enhanced efficiency and increased income and collection of taxes. The projected proceedings from privatisation of the biggest companies and banks will serve as a reserve and insurance against possible misperformance. A fact speaking for this is the significant excess in budget revenues and expenditures during 1998 (as of November 17th by 22 % and 18 % respectively recalculated in on annual basis). Given the particular circumstances in Bulgaria the effect of the decrease of the tax rates will become visible even in the first years.

The increase of the budget-financed investments is not an alternative to a decrease of the tax rates.

5. For each level of state revenues there are numerous possible sets of taxes through which the necessary funds can be raised so that the state can perform its allocation functions. A tax-structure is called Pareto-effective when nobody could improve his welfare without somebody else to becoming poorer within a fixed level of state revenues. Furthermore, any choice of a particular tax-structure influences in a different way the production, consumption and employment and results in many deformations, that impede the efficiency of the economy. The optimising of the tax rates is aimed at minimising the inevitable loss of economic efficiency.

Science has not yet offered a precise prescription for a tax system with maximum efficiency. Most of the results obtained are rather qualitative and are not subject to accurate measurement in practice. In the same time any change in the tax system has a direct bearing on the drafting of the State Budget Act and requires a most precise evaluation of the implications of any changes in the tax system. The question is therefore, whether it is possible in practice to optimise the tax system?

The answer is “Yes”, as evidences from the proposed practical scheme for optimisation, based on relatively simple mathematical equations.

The following main issues of the particular situation in Bulgaria have been taken into account:

• reducing the tax rates could lead to significant positive effects for the economy, that must be accounted for when evaluating the net tax effect of tax-decreases on the state revenues;

• the main indirect effect of the tax-decrease would be expressed not mainly in the decrease of the dead weight of the loss, caused by malformations, but in accelerating the growth of the GDP;

• the partial legalisation of the shadow economy provides a bigger potential for accounting growth in the GDP, than the increase of real investments and employment.

For these reasons the proposed scheme for optimisation is based on identifying an adequate quantitative expression of the following sound economic logic:

$$\begin{matrix}\text{Net tax}\\\text{effect}\end{matrix} = \begin{bmatrix}\text{lower}\\\text{taxes}\end{bmatrix} \times \begin{bmatrix}\text{higher}\\\text{growth}\end{bmatrix} - \begin{bmatrix}\text{basic}\\\text{taxes}\end{bmatrix} \times \begin{bmatrix}\text{basic}\\\text{growth}\end{bmatrix}$$

This dependence has been put in a mathematical equation by simplifying the reality though aggregate consideration of the overall GDP, using the Cobb-Douglas productivity function for economic growth. The following formulas are given for the two basic cases:

• *total change of a part of the tax rates* (on all taxable units – present and emerging as a result of alleviation) ;

• *preferential change* of a part of the tax rates (on the taxable units emerging as a result of alleviations only)

In order to achieve maximum realism of the model, we could take into account, by applying adequate production and usefulness functions, the linkages between all the branches of the GDP and different types of consumers (depending on their income), as well as the appropriate elasticity.

The scheme for optimisation of the tax rates is based on the sequenced calculation of a break-even increase of the growth of the GDP that assures the achievement of the desirable net tax effect in different options of changes in the rates. Thus one could perform an expert evaluation of several Paretto-effective tax systems and chose the best one in terms of the equity, simplicity and flexibility.

An overall assessment of the tax policy in Bulgaria from the viewpoint of the proposed system shows, that the amendments made so far in the taxes (including these of the end of 1998) have not the nature of optimisation. This means that the true optimisation in the Bulgarian tax system, aimed at enhancing economic efficiency, is still ahead. And only the systematic approach to the problem, based both on economic, and on the detailed quantitative analyses with maximum possible accounting of the complex interrelations in the economy, could lead to the establishment of a maximally effective and simplified tax system.

COMMENT

Peter Stella

Resident Representative for Bulgaria, International Monetary Fund

I am grateful to the Center for Economic Development and the Agency for Economic Analysis and Forecasting for inviting me to participate in this conference. I also want to thank Paul Reynolds and professor Dabrovski from Poland for commenting on the tax holiday issues. I have nothing to add but say that I agree with what they said. All of our experience and research back up what Paul Reynolds said about the tax holidays.

The paper that I'm commenting on really goes to some of the fundamental issues in political economy, namely how much of the economy resources should go to the state, how much should be allocated by private sector and individuals. Generally I agree with the conclusions of the paper for the case of Bulgaria today that more of the resources need to go to the private sector and individuals and less in the hands of the state. One of the indicators for that is the transfer of physical property from the state back to the citizens of the state. What I'd like to do is broaden a bit the discussion in the paper about tax policy and I think it's particularly important for transition economies that the so called traditional conventional taxes on the profits of legal entities are not the sole subject of consideration. It is necessary to consider what I call "the occult taxes" or "the hidden taxes" that are present in many transition economies and a number of developed economies as well to a lesser extent. These are of particular importance for Bulgaria.

I would like to give two examples of what I'm talking about. First, I have in mind interference with trade of goods and here one could take the example of interfering with exports and imports of certain commodities. A lot of governments are trying to stabilise the prices of certain commodities including some stock goods. Let's take grain for example. What they tend to do is say: "When the world market price of grain is very high, the price at home should not be too high so exports of grain will be prohibited." This isn't written in the tax law anywhere, but in fact it's a tax on the producers of grain and is at the same time a

concealed subsidy to the consumers of grain products. So it's a tax completely offset by the state expenditure. When the opposite tendency is valid and the world market price of grain falls, the state tries to protect the national producers of grain and prohibits the import of grain constituting a concealed tax on consumers and at the same time a concealed subsidy to the producers. Obviously this is a mechanism of the state to unreservedly interfere with the reaction of the market, with price signals, which is a fundamental inefficiency no matter how much developed an economy is.

Researches show that actions of the kind make it much more difficult for the grain producers. My personal experience also shows that farmers tend to constantly lose money. But every once in a while prices go up and they realise additional profit. If they manage to keep these profits they will be able to invest and in the long run survive. But if they are deprived of this opportunity in cases of increase of prices in external markets on the one hand and the state devoid them of this additional income either directly or through a tax or simply by prohibiting exports on the other hand, then agricultural production is doomed. Basically, if they are not given the opportunity to take advantage of the accidental benefit of their business they will not take the risk to carry on at all.

So one of the positive tendencies observed in Bulgaria right now is limitation of state interference in trade and I view that as a decrease in taxation.

Another issue of what I call occult taxation or obscured taxation is the inflation tax. I would like to point out that in 1997 we witnessed probably the single largest permanent tax cut in the history of Bulgaria. You might ask yourselves: "Which tax was reduced?" What do I mean? According to the official figures, tax revenue as a percentage of the GDP was higher in 1997 than it was in 1996 and in 1998 it was still higher than that in 1997. How can we talk then of tax cut? This was possible owing to the introduction of the currency board. I think Mr. Angarski can take credit for the biggest absolute tax cut in the whole Bulgarian history. This tax, however, cannot be found in the official statistics, because the inflation tax in itself is never recorded. The government budget t does not have an item or a line where the inflation tax is registered.

At the same time all the expenditure related to the inflation tax never appears in the government's budget. No one ever voted on it. And as Professor Petrov and his associate mention on the paper, the expenditure connected with this tax were probably some of the most inefficient, corrupt even criminal I should say. How could we measure the impact of this tax cut? Certainly the people who lost their life savings in the banking system have a sense that they paid a tax. People who saw their wages crumble to nothing can understand what I am talking about. One way to get an idea of the magnitude of the process is considering the government's interest payments percentage of GDP. In 1995 they came up to 14.1% of GDP, in 1996 they were 19.7% of GDP, in 1997 they had already fallen to 7.9% of GDP and in 1998 they were 3.9% of GDP. So this gives you an idea of the magnitude of the tax cut due to the introduction of the currency board.

Another interesting aspect of tax cut is connected with the automatic cut in expenses. On the one hand tax was cut and on the other hand expenses were reduced. Practically in my opinion this was actually a tax where lowering the rate of taxation led to an increase in the real revenue from the tax. It is really possible to cut the tax rate and get more revenue. The researches suggest that inflation tax is the one tax where you can get more revenue at a lower rate, because as you all have probably lived through, at a point when the inflation tax is so high people just stop using their own currency be it Bulgarian or French or any other currency so the tax base shrinks almost to nothing. So when considering the currency board (besides, I have not heard any serious critics of it) we should not forget its impact on the hidden tax burden, the population and the occult off-budget expenses associated with financing it.

I would like to say a few words about taxation of labour in Bulgaria, which seems to be a real problem as the authors of the Report State. We can view this from the competitive aspect of economy. Argentina, for example, is thinking of dramatic cut in payroll taxes and labour expenses as a consequence of what is happening in neighbouring Brazil; in this connection a decrease in the taxes for the social security and the social payments is undertaken.

In Bulgaria the payroll tax comes up to 40–42 % of the wage. That is extremely high. About 60% of the population are employed in the private sector and only about 6% of the social security revenue come from the private sector. So that means 94% of the revenue for social payments comes from the public sector. How can we explain this? Supposedly the public sector wages are much, much higher than the private sector wages, which I find a little doubtful. Another hypothesis concerns the fact that the actual tax on employees in the public sector is higher than that on the private sector or maybe people in the public sector are in early retirement categories and pay higher marginal social security contribution. This does not sound veritable enough. If you do a little calculation in connection with the relative level of wages, you can come to the conclusion that the private sector is maybe paying 6-10 % of what they ought to be paying in social security contributions. So what does that mean in a country where a speeded privatisation is being carried out? It means that if all the public sector employees in industry went into the private sector and if those social security contributions fell to the average in the private sector, then the social security system would lose 300 or 400 million dollars a year, which would be a devastating blow. That would suddenly impose a tax increase on the private sector of 300 or 400 million dollars a year, which could very well crush economy. There is a fundamental problem here. If we insist on a hundred percent compliance today, the private sector will hardly survive. There exists an obvious link between decrease in tax burden and abiding a tax discipline.

So in my opinion those are the main issues which should be considered in relation to tax policy.

POTENTIAL OF THE FINANCIAL SYSTEM FOR STIMULATING ECONOMIC GROWTH

Georgi Zamanov

United Bulgarian Bank

I. CURRENT STATUS

The transition to a market economy has brought the issue of changing the *financial system*. Under a planned economy, the financial sector played the role of a bookkeeper for the real sector and the public enterprises. Resources were distributed in a centralised manner by the Bulgarian National Bank (BNB), which acted also as a universal commercial bank. There was a significant volume of "forced" savings.

Over the first transition years, efforts to introduce "new rules of the game" brought the following results:

1. *End of the monopoly situation in the sector*. A new legal framework was established.
2. *Decentralised management* of state financial institutions:
• *Administrative autonomy;*
• *Autonomy in resource management.*
3. *Private capital* allowed.
4. *Privatisation.*
5. *Increased competition.*
6. *New financial products.*
7. *Increased number of branches and offices*.

Transformation processes in the Bulgarian financial sector did not affect the leading position of commercial banks as intermediaries of savings and loans. They continue to be the main player on the money and lending market.

At the beginning, notable progress was made in restructuring the banking system into a two-tier one and reengineering BNB into a typical central bank implementing the country's monetary policy. On the basis of BNB's branches, numerous new commercial banks were set up with government capital; private banks emerged gradually, to be followed, after 1993, by the first foreign banks. At the same time, the government policy in managing the banking system was carried out through BNB.

1. The *bureaucratic approach to management* was too far removed from the market principles of managing the economy.
2. *Through its participation in the Bank Consolidation Company (BCC), BNB* remained as an owner/executive of the state-owned commercial banks, which conflicts with its functions as a supervisory body and the national monetary policymaker.
3. *The lack* of any meaningful presence *of foreign bank capital* deprived the Bulgarian market of any competition.
4. *A policy of tolerating certain banks* was applied.
5. The new commercial banks had limited resources (low capital and lack of public trust). To expand on the market, they needed funds; and they obtained these from BNB and the State Savings Bank. The central bank's *credit expansion* resulted in significant *inflation rate* levels in our country.

The 1996 – 1997 Banking Crisis. The inadequate government policy with regard to the financial system and the slow down in the transformation of the government-banking sector led to one of the largest banking crises in recent European history. Between 1996 and 1997, one third of Bulgaria's banks holding a quarter of all assets went under. The large volumes of bad debt in these commercial banks' portfolios, lack of capital, disturbed liquidity came as the direct outcomes of bad bank management and the lack of adequate bank supervision. As a result, trust in the banking system plunged down and remains low, with the public continuing to hold in hand significant amounts of cash, thus withholding investment potential away from the economy.

Recapitalisation schemes. Attempts to improve the financial health of Bulgarian banks have failed. The stabilisation policy aimed at removing the consequences rather than the causes that had led to their poor financial condition. Efforts targeted the improvement of short-term ratios – mostly capital adequacy, without providing the banks with any conditions for normal operation in the long term.

The Banking Sector after the Introduction of the Currency Board Rules. With the introduction of the Currency Board rules,

Figure 1

Aggregated Total Assets in the Banking System

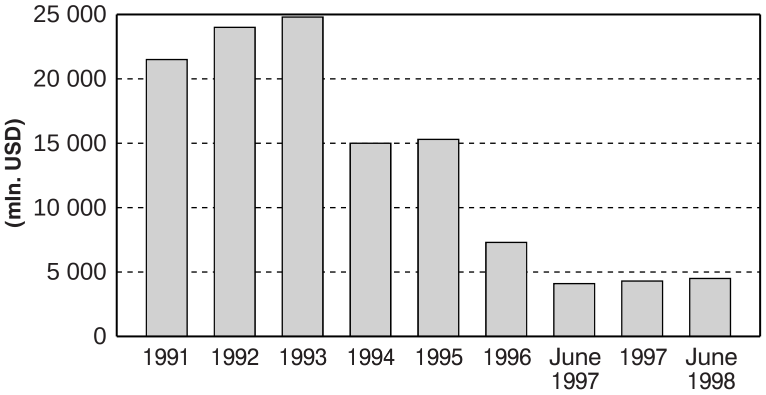
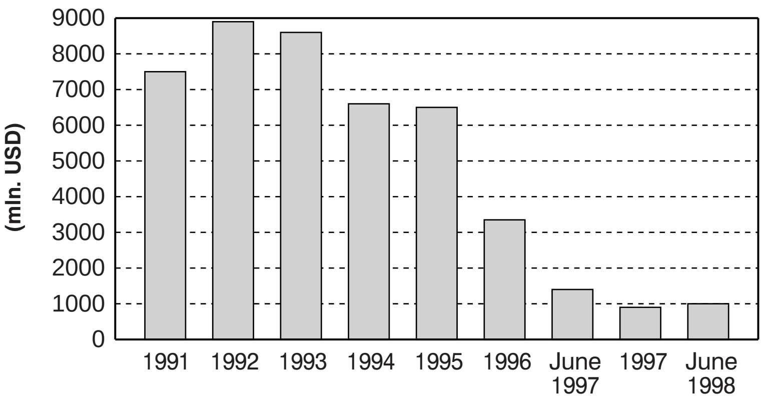


Figure 2

Aggregated Amount of Loans Made in the Banking System to Non-Financial Institutions



the banking system is slowly emerging from the crisis situation and a process of financial stabilisation of the operating commercial banks can be observed. This stabilisation came, on the one hand, as the result of the restrictive measures undertaken, such as closing down banks in an extremely grim financial con-

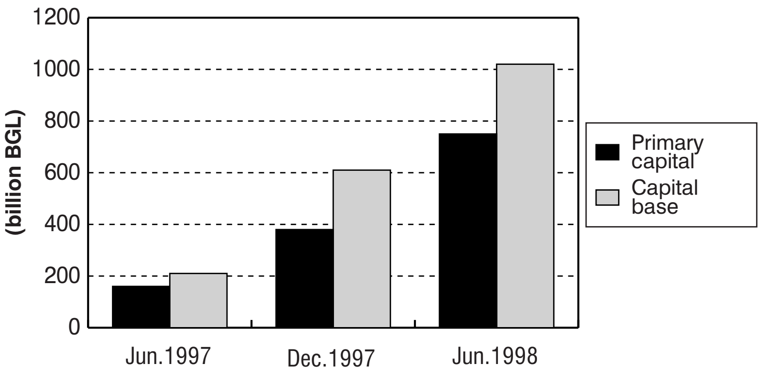
dition and imposing restrictions on the operation of banks undergoing temporary difficulties, and, on the other, of the macroeconomic stabilisation which followed the introduction of the Currency Board rules and the political changes that occurred.

In general, the developments in the banking sector between January 1997 and June 1998 could be divided into two periods. The first period, the one prior to the introduction of the Currency Board, can be described with macroeconomic instability: a sharp devaluation of the national currency, hyperinflation, and a drop in production. The second period, after the introduction of the Currency Board, is characterised by a gradual macroeconomic stabilisation of monetary indicators and a considerable improvement in financial discipline.

During the first period, most of the operating commercial banks significantly improved their capital adequacy ratios by provisioning for a large part of their doubtful loans. It is noteworthy that commercial banks managed to meet the provision requirements for covering their expositions as a result of the high net gain from foreign exchange caused by the devaluation of the Bulgarian lev.

Figure 3

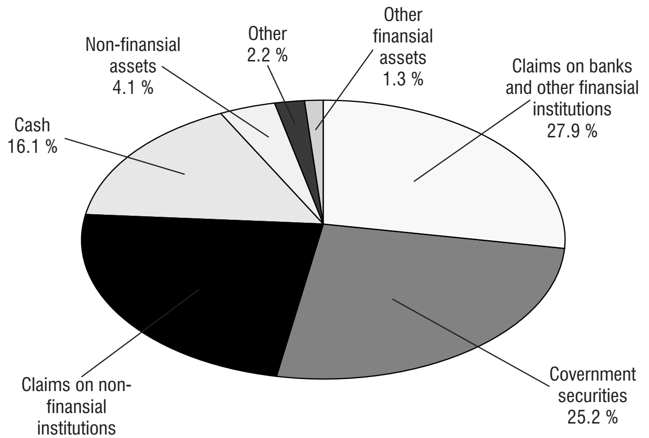
Capital Base vs. Primary Capital – in billion BGL



The devaluation, in real terms, of bank liabilities due to the hyperinflation at the beginning of the year acted as a crucial factor in improving liquidity in the banking sector in the middle of the year. The high liquidity of the banks, paired with low "effective" demand and the relatively low requirement of the Treasury for internal borrowing became the main reason for a record low in interest rates during the last months of the year. This latter factor, combined with a fixing of the exchange rates, provides favourable conditions for revamping long-term lending.

Figure 4

Asset Structure as of June 1998



The low interest rates on deposits (which were negative in real terms during some of these months) provided no incentive for economic agents to put their idle funds into commercial banks. Most of the foreign currency funds held by individuals remain outside the banks, with economic agents continuing to make payments in non-banking manners. Income from banking transactions was low due to the low supply of loanable funds, with a large portion of them being invested in government securities, low quality and a lack of variety in the banking products offered. Another problem encountered by some of the banks was the large and inefficiently set up branch network, with its high cost of maintenance.

• Characteristics of the banks' investment activity:

• Maintaining high liquidity: in cash and government securities, with liquid assets accounting for 69% of total assets;

• Export of capital: putting funds in deposit accounts abroad, with total amount of deposits in non-local banks exceeding the amount loaned to the real sector;

• Low lending activity: refraining from lending to the non-financial sector.

Financing the Banks. Banks followed a policy of raising stable and cheap funds: resources attracted from non-financial institutions cover two-thirds of asset transactions of the banks. Own funds were also significant in volume, with owner's equity standing at over 14.4% of banking resources (over USD 600 million).

II. PROBLEMS IN THE BANKING SYSTEM

Despite the reforms undertaken in the country's financial system, there are a number of problems, reflecting the stagnation of the real economy following the dramatic recession and the banking crisis.

II.1 Size-related Problems (related to the potential of the banking system)

1. Low investment potential. Total assets of all banks operating on the territory of the country are significantly less than the assets of an average-sized regional bank in an EU country of Bulgaria's size. The total banking system assets to GDP ratio is only 35%, while in developed country this ratio is over 100%.

Table 1

The Banking System in GDP Terms

June 1997 – June 1998	**In BGL billion**	**% of GDP**
Average aggregate assets in the banking system	7.378	35.2
Average aggregate loans to non-financial sector	1.941	9.3
GDP generated for the period	20.939	
	Bank Assets / GDP	**Loans / GDP**
Bulgaria	35%	9%
Poland	39%	15%
Slovenia	69%	52%
Czech Republic	182%	79%
Israel	123%	86%

2. *Underdeveloped banking sector* manifested in the domination of commercial banks (almost complete absence of mortgage banks, investment banks).

3. Low trust in banks among clients.

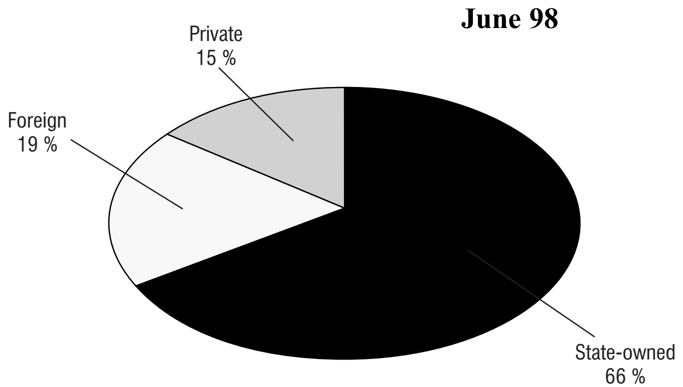
4. *A very narrow market of bank services.* The quantity and quality of banking services and bank products offered is quite indicative of the development level of the banking system. The most serious problem is the "removed position" of banks vis-a-vis their clients. There is no market research and, consequently, products marketed by the banks do not meet the requirements or the needs of potential clients.

II.2 Problems of institutional frameworks

1. *Clear-cut oligopoly structure.* Several large corporations (banks, insurance companies) manage over three-quarters of the industry.

Figure 5

Bank Asset Structure by Type of Ownership



2. *Strong affiliations* among financial companies, both on equity basis (often involving also a pure capital swap) and on the basis of debt. Financial conglomerates are being set up, which are not subject to supervision on a consolidated basis. The lack of sufficient capital and the strong affiliations among the individual players create conditions for strong quakes in the financial system as a whole, as a possibility for chain bankruptcies.

3. *Slow-down in privatisation.* Most of the state-owned financial companies, which shape up the structure of the system have not been privatised.

4. *Lack of* sufficiently large *international financial institutions* on the Bulgarian market which could, with their image, product and customer service quality, quickly win back trust in the financial system and would foster competition.

5. *Corruption.*

6. Unsatisfactory performance of the managers of state-owned financial companies, irreplaceability even in the case of inadequate management that has brought huge losses.

7. *Underdeveloped stock market.*

8. *Small range of financial services and instruments.*

9. *Inferior service quality.*

10. *Personnel* (including senior management) *lacking the necessary knowledge* and professional experience.

11. *Lack of public trust*. After the failure of one-third of the banks and of the financial pyramids, small investors suffer a psychological block and would rather hold their savings in hand and not entrust them to financial institutions. The amount of cash in hand is commensurate to that held at the banks.

12. *Grey economy*. Illegal business avoids using services offered by the financial institutions in order to avoid paying taxes or to cover up illegal dealings.

13. *Inadequate oversight/supervision* from authorised institutions such as the BNB Bank Supervision, the Insurance Supervision Directorate, the Securities and Stock Exchange Commission.

Table 2

Competitiveness Indicators / Financial System Development

№	Main Criteria and Ratios	A	B
1	Degree of development of financial markets	2.12	53
2	Access to venture capital for start-up businesses	2.72	48
3	Local banks in Bulgaria encountering competition from foreign banks	4.56	37
4	Equal opportunity for clients – large vs. small businesses	3.56	50
5	Financial stability of banks	3.46	42

№	Main Criteria and Ratios	A	B
6	Interest margin (lending and deposit rates) compared to international levels	2.78	34
7	Stock exchanges as a source of capital for companies	2.18	52
8	Development of the bond market	2.28	54
9	Regulation and supervision of financial institutions	3.92	44
10	New banks entry	3.40	47
11	Market determination of interest rates on deposits and loans	3.66	45
12	Insider trading (applicable to stock market)	3.61	41
13	Gross investment as a percentage of GDP (for 1997) 1991 – 22.6%; 1992 – 19.9%; 1993 – 15.3%; 1994 – 9.4%; 1995 – 15.7%; 1996 – 8.4%; 1997 – 11.8%		54
14	Change in gross investment as a percentage of GDP (1992 – 1997)		49
15	Gross savings as a percentage of GDP		51
16	Change in gross savings (1992 – 1997)		28
17	Share of lending to the private sector in domestic lending		50
18	Credit rating of the country – Moody's B2; Fitch IBCA B+		
	Mean of values by column	3.16	45

Note: **A** – average score for a sample of 50 financial enterprises (on a scale of 7); **B** – Place in which the country would have been ranked among the 53 countries examined (Bulgaria not included)

Characteristics of the short-term and mid-term (3 – 5 years) development of the financial sector.

A prevailing factor in the development of the financial sector will be the future development of the real sector and the privatisation process of both financial and non-financial enterprises. Macroeconomic stabilisation, which has occurred with the introduction of the Currency Board rules, provides a favourable environment for the development of the financial sector. Yet the general situation in a mid-term perspective will be characterised by a period of stagnation. In the short run, it is expected that most investments to be made will be direct, not involving financial intermediation. Many financial companies will put their efforts into providing financing for small and medium businesses. In that regard, new product and service packages will be developed. New economic conditions and a stricter financial discipline will require greater flexibility in management and improving customer service.

The future of banking lies in its improved service quality, offering custom-tailored products, providing access to international financial markets, a client-centred approach.

III. ECONOMIC POLICY GOALS REGARDING THE BANKING SECTOR

A priority strategic goal of the policy implemented should be to promote the development of a healthy and efficient financial system. The financial system should meet the following criteria:

Efficient coverage/performance of the functions to gather existing savings and distribute them efficiently;

Discipline in economic agents' activities;

Successful competition with international financial institutions, i.e. complete liberalisation of services in view of the forthcoming accession to the European Union.

The policy with regard to the banking sector will target the following basic criteria:

1. Revitalising its activity and its operations in the process of economic growth by increasing capital resources, confidence in bank transactions and developing the market for long-term financing;

2. Strengthening BNB independence. Ensuring conditions for non-interference with the operation of the bank's Issuance Department acting as a Currency Board. Setting up bank supervision that is efficient and works;

3. Ensuring protection against "slipping back into bad debt", together with continuous monitoring of the situation in that area;

4. Wider use of local banks in managing government assets and privatisation of state-owned enterprises;

5. A consistent policy of reducing the government share and removing the oligopoly in the banking and insurance markets. Without this, local banks and insurance companies would not be able to cope with a Bulgarian market open for the entry of foreign companies which, in view of our future EU membership,

would come to our country over the next years;

6. Undertaking actions to ensure sustainability and further development of capital markets so as to increase their participation in the resource distribution function in our economy, complementing traditional banking mechanisms and instruments for the accumulation of capital and credit for municipal infrastructure development;

7. Providing conditions for improving trust in the securities market; basic market principles functioning properly; saturate the market to the level of volumes ensuring adequate liquidity and diversification; more effective protection of non-professional investors;

8. An open, yet selective, policy of providing access to foreign capital to the local financial market, a policy promoting their entry first into areas where there is a lack of local investors.

IV. TOOLS / METHODS

Defining strategic goals is related to specific tools and methods of implementation.

1. Privatisation;
2. Actions aimed at increasing the capital of financial institutions;
3. Promote and support the process of commercial bank consolidation;
4. Increase the independence of management bodies of state-owned banks from bureaucratic government intervention;
5. Set up legal, organisational and financial frameworks for the development of a guarantee system promoting small and medium enterprises, especially at the regional level;
6. Set up and accumulate an efficient Bank Guarantee Fund to insure bank deposits. This would free the central bank and the government budget from their involvement in that area.

V. THREATS / POSSIBLE PROBLEMS

1. Inefficient implementation of the financial sector reform and a slow-down in privatisation. Reform and privatisation could make it more efficient, representative, competitive and bring about growth-oriented transactions;
2. Loss of control over the penetration of foreign business (supported by its capital strength and technical advantages) as a result of shifting some of the economic policy tools beyond the national boundaries;
3. Inefficient local capital.

VI. MEASURING THE OUTCOMES

Financing the non-financial sector at a level equal to at least 20 % of GDP.

COMMENT

Stoyan Alexandrov

Chairman, Association of Commercial Banks, Sofia

It is obvious that I do not have the time to make more detailed comments on the issues being discussed today although I was tempted on many occasions to take the floor when either strictly banking issues, or issues of the privatisation process or of the taxation policies were on focus. There is an undoubted fact, namely, what has been achieved in terms of economic, political and financial stabilisation is quite significant. I am pleasantly surprised that all speakers, including the representatives of the Government, have expressed their concern for promoting an economic growth because the stability will remain very fragile and temporary. I have stated it more than once that the successes scored should not cause complacency, since sometimes even small obstacles can cause major problems. As for me, who am basically with a pessimistic mind set, I have reached a conclusion that the economic growth will inevitably be accompanied with problems. Whether we can secure growth or not is a very controversial question, because everything boils down to resources. Of course, we must have a vision, strategies and approaches, but we must also have money in order to accomplish the reform.

At present we are in a situation which reminds one of the fable about the pig and the pumpkin. We have our objective set and we know what will happen if we find a way ‘to bite the pumpkin’, but the question is that it is rolling over and over and there is no way to bite it. We also know that the economic growth is like ‘the pumpkin which must be bitten’, but the problem is how to do that.

What is the situation in view of the banking sector? I would like to dwell on a few aspects of this issue. And I do agree with what my colleague concluded – that the Bulgarian banking system (here I include the foreign banks as well since they operate as local legal entities) does not have the economic potential to secure funding for restructuring the economy which will guarantee the economic growth. It is quite useless to be under a delusion. I mean a global aspect as a resource of the banking system. There are however some other problems to be taken into account as well when discussing the Bulgarian banking system. One of the global problems of our banking system is the fact that most of its resources are short-term ones. These are funds of vision. Reliance on such short-term resources, which could simply disappear all at once, may cause extremely serious problems. In the context of the banking system of this country this is much more so with all negative implications.

This is exactly where our banks will be most vulnerable if they participate more actively in funding and lending to the economy. In the event of even minor protuberances in the economy, and such can occur as a result of the global financial crisis, of mistakes in the management of the economy, etc., this will result in a destabilisation of the banking system and will place the banks in a very difficult situation. That is the reason why even the biggest banks maintain big amounts of cash as their assets. And such assets are readily liquid, but not yielding enough. This is the price we pay for the fear of the bankers who have not yet overcome the nightmare they were in two years ago. And to this we have to add the public opinion, the mass media and sometimes even the politicians who continue to maintain the view that the people working in the banking system are rogues who drain the banks for their personal benefit. This has a most negative effect.

At present something undesirable is happening with one of the banks now. Some people see the possible bankruptcy of Credit Bank as a signal that the Board is facing a failure that the banking system is at the threshold of a new collapse. Unfortunately even prominent economists and financists, experts that I do respect, are taking such a stand. It is wrong to state that once we have a Board, there can be no bankruptcy of banks. There are banks in bankruptcy but the effects are different from the time when the collapse of one bank could cause the collapse of other banks as well.

And again I do point out that a major problem we are having now is the one with the short-term resource. There is a ground rule in banking – short-term resources are not spent on long-term investments. And each loan – be it for operational capital even – is a long-term investment. If you look at the structure of resources, you will see that these are mainly funds on accounts, on payments accounts or one-month, maximum up to three-month deposits not even one-year deposits. And each loan is borrowed for at least 5–6 months, or one year, leaving aside investment loans or privatisation loans, etc. Provided that we observe the ground rules that you may find in each banking textbook, we must simply stop lending under the existing conditions in the country.

We hoped that the foreign banks would bring about an inflow of foreign capital. Having analysed their presence in the country for some years now, I have serious reservations concerning their actual contribution to the improvement of the banking services, to the establishment of the principles of fair competition, to know-how transfer, management, etc. What we mostly expected from them was that they would bring in resources from abroad and invest in our economy. The result is just the opposite. Due to their better reputation, the companies, the most stable companies keep their accounts with these banks; citizens keep their deposits there. These banks, however, do not lend to the real economy; they redeposit these funds abroad. In other words, they drain Bulgarian resources and channel them abroad, instead of bringing in foreign resources in the country, as we hoped.

Now, with the development of the global crisis, these banks were immediately given instructions from their headquarters to change policies, cut off half of the Bulgarian banks that they are working with, check their clients again, etc. In other words, they are not open-minded to the problems of our economy. Their balance-sheets may show positive results, due to the simple reason that they take the best ‘pies’ of our economy, i.e. the companies privatised and bought by serious investors. But they will not work with our problematic enterprises and problematic economy. So this is a very interesting issue and I will disagree with the colleague who stated that we have to hurry up with the privatisation of the Bulgarian banks. Well, I am not against it, and I have always maintained that, but to sell a bank at whatever price only to be able to report that you have concluded a privatisation deal or that there is no Bulgarian banking system any more – this is not the best thing to do, in my view.

I do not believe that a foreign management of Express Bank will immediately make it a different bank, or that Bulbank will become a better bank for the same reason. On the contrary, I am deeply convinced that deep disturbances will occur in these banks when their new owners take control. And the biggest problem is in the fact that no first class banks would like to enter Bulgaria. We will warmly welcome these 12 or 13 banks to our country, but only 1 or 2 of the ones operating here are really serious banks. They have no branch network scarcely any clients and are only involved in some kinds of transactions that are not always decent. But it is the persons who permitted these banks to operate here placing no requirements that are to blame for this.

At the same time many of the branches of the foreign banks have set preferential conditions as compared to the Bulgarian banks, due to the simple fact that there is no requirement that they should invest their own capital and can therefore attract Bulgarian enterprises with whatever means they wish. They offer them loans without requiring security, and when the banking supervision department checks, they immediately produce guarantees from their headquarters. This is how they steal enterprises and create problems for the other banks, which causes an effect different from the expected. The situation is really complicated but they have to get used to working under these conditions. Maybe with time they will learn to do so.

Another big problem that raises the concern of the banking community this year is the fact that we do not know what the parameters of the global financial crisis are. This requires from the banks to double the attention when investing – either in securities in order to maintain better liquidity and guarantee a definite yield or in specific capital improvement projects. Even the best performing enterprises have gone into collapse due to the financial crisis and the loss of markets, mainly the Russian markets. Last year there were no problems with the canning enterprises when the banks served them. They were desired clients. This year, however, the situation now has changed dramatically – full storehouses, no sales and regretfully no prospects. And if we can not lend to canning enterprises, how can we lend to agricultural producers? The Bulgarian enterprises cannot find a niche, a market segment in the global economic network. It is very difficult for them to readjust from one market to another without any investment, since for this purpose their goods must have a different technological level and marketable shape. This in itself is a serious problem. Whether it is food processing industry, or tobacco industry, or heavy chemical industry or metallurgy – all these are branches suffering enormous difficulties, even collapsing. Which is due, among others – to the conditions at the international markets. That is why I say this proves to be neither fault nor mistake of the management's recipe.

Another problem that causes concern in the banking sector is the delay in the privatisation. It is a general rule that when an enterprise reaches the point of privatisation, it has already stopped working. The objective is to have its price fall down, in order to make its sale possible. No matter whether the managers work for their own benefit or for an outside client, the manner of conduct is always the same – to drain it of resources, devastate it, crush it down, etc. Well, how can a bank work with an enterprise like that? And yet another problem connected with privatisation stems from the workers-managers partnerships (WMP). I have been insistently stressing on this, but enterprises have been really given to WMPs in an absurd way. What happens is – the enterprise is brought to frustration by the management of this same enterprise and then the latter is given to the former? The privatisation agency should step on the assumption that either the managers have deliberately brought the enterprise to that state and in such case they should be held responsible and the enterprise should not be given to them, or else they do not have the potential to manage it properly. If that is the case – why should they be given the enterprise? Besides, even with the most conscientious WMP there is yet another problem that emerges, i.e. the mentality of the Bulgarians who cannot assume the role of shareholders and owners. Their attitudes are different; they would rather take whatever they can of the money today. With WMP that undertake to incur rescheduled payment, the enterprises have one objective – to distribute their whole profit as dividends in order to make the next instalment. Which means that they do not work with a long-term perspective. They work on a day-to-day basis and the enterprise cannot therefore occupy stable positions.

Then what is the alternative? Either the enterprise will strive for some years on end just for the sake of paying the instalments, or the opposite, when they see no more prospects of paying out the instalments, the enterprise will be squandered on till full exhaustion and then passed over to the bank that has supplied loans. The other alternative is to give it back to the privatisation body because it turns out to bring little profit.

I do not want to pose as a defender of the whole banking system, but there are real objective reasons that force the banks to refrain from lending. I would not say that they have stopped lending even in the condition of chaos prevailing in our economy / financial stability is a different thing/. It is real economy I mean, the banks take risks when extending loans. They do not have other alternatives, of course, especially with the collapse of the capital markets, and the impossibility to earn it from long exposures, from sale and purchase of forex, etc. They have to take risks and lend, in order to secure their maintenance. What are more the expenses of the banks themselves are also growing – for telephone, fax, EDP, fuel, etc. Therefore they cannot but lend. But what we heard of in the report investing in securities in such big scales is not normal. If we add the cash available it means that a very small portion of the assets are in loans. There is really some potential, but this is the situation now and there is something very indicative. The banks are deliberately keeping low interest rates on deposits and payments accounts. Some of them are not interested in attracting funds, their rationale being: "If things go to the worse, then at least we shall not have remorse of consciousness of having cheated the people". On the other hand, it is enough to redeposit the cheap resource abroad and gain a small margin for the maintenance of the bank. It does not matter that much greater profit can be realised, what matters now is to survive, to keep ourselves on the surface. This is true of both private and state-owned banks. The state showed once again how incapable it is of managing. No state bank having certain resources and potential, having achieved certain economic indicators, and signed a management contract is paid a certain sum of money. I have often said, be it trivial, whether a bank will have 5 bn or 50 bn profit, nobody will say 'Thank you'. And since privatisation is pending, it has to take to risky operations in order to realise big profits, because the managers want to be placed well before the new owners when they come.

This is yet another reason that influences the conduct of the bankers, as well as some other things I would not like to discuss now. The distinction that all governments so far, including the present one regretfully, have made between state-owned and private banks causes problems. There are invented all kinds of rules showing different approaches to banks and this naturally creates mistrust in the clients of the banks, because if you are not in the list of banks servicing the budget, then you are an inferior class bank. This is the way of thinking of the common client – 'these are the bad ones' and 'those are the excellent ones'. However, the excellent ones are under privatisation and soon they will have a different behaviour.

These are some of the issues that I would be happy to discuss in greater details. To conclude, I would like to say that, in spite of all, I am optimistic and do believe that there will be a Bulgarian banking system and that it will not stand apart when the complicated problems of our economy are to be solved. The only thing that the banks need is somewhat greater confidence – on the part of clients and Government.

SUMMARY AND CLOSING SPEECH

Mariela Nenova

Chairman, Agency for Economic Analysis and Forecasting, Sofia

I would like to thank all the participants in the conference, the audience and those who took an active part in it. It is difficult to summarise in one minute all that was said since the topic is obviously a broad and very controversial one. First, it is worth mentioning that the government has already made a lot to accelerate economic growth. A few issues of consensus have been laid down in the discussion.

One of those issues of consensus is the necessity for clear property relations as a precondition for economic growth. This means that the privatisation of what has been decided to be privatised, should be completed as soon as possible.

The other issue of consensus is the establishment of a stable legal framework, which ensures the economic agents' security as far as the rules of the game are concerned. This fact requires a completion of legislation changes, i.e. a completion of the legislation framework of a market economy. It is clear that the Bulgarian legislation framework should be guided by our strategy of joining the European Union and harmonising our legislation with that of the European Union. Other issues of consensus have been laid out, however I cannot dwell on them now. The economic growth is very important for Bulgaria and if it is not achieved, then the impact of the macroeconomics stabilisation will be lost. The topic provokes a lively discussion with really different opinions on some major problems of the economic growth.

The first topic to discuss is about the priority of some directions of development and the available tax preferences, or some other. The discussions of such policy extend beyond the hall we are in now. There are really opposite opinions. In this connection I would like to repeat the words of Andrew Warner from the Harvard Institute for International Development: contrary to the economic logic preferences allow for preservation and long life of sectors and activities that have reached “maturity”. Due to that fact they have their lobby which protects them and just because they are in the age of maturity before reaching old age and “death” they need preferences to stay alive. At the same time what is new and is just now emerging, is either invisible for us or we are not able to evaluate its future potential or it has not got its own lobby and nobody takes care of it. However, the preservation of dying branches and activities shrink the resource necessary for the new thing to grow and bring about the overall social progress. So this kind of logic is economically based and comprises an excellent argument, a good reason for thinking over all the suggestions for tax or other kinds of preferences that we propose for one sector or another.

Of course, this is my point of view. As you could see it is a very controversial issue. We intend to issue, to publish these papers, the comments on them, the discussion itself, so that all of you could have the chance of reading them once again and assessing your stand on those issues. This conference, in fact, opens the discussion. It does not close it and its task is to help the government and all those who make the economic policy make it in such a way that it should lead to the actual acceleration of the economic growth.

Thank you.